SMALL BUSINESS FAILURES

HEARING

BEFORE THE

SUBCOMMITTEE ON ANTITRUST AND RESTRAINT OF TRADE ACTIVITIES AFFECTING SMALL BUSINESS

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

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SMALL BUSINESS FAILURES

FRIDAY, JUNE 25, 1982

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON ANTITRUST AND RESTRAINT OF TRADE ACTIVITIES AFFECTING SMALL BUSINESS, COMMITTEE ON SMALL BUSINESS,
New York City, N.Y.

The subcommittee met, pursuant to notice, at 9 a.m., in room 305-A, 26 Federal Plaza, New York City, N.Y., Hon. Thomas A. Luken (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN LUKEN

Mr. LUKEN. The hearing will be in order.

This session of the House Committee on Small Business, the Subcommittee on Antitrust and Restraint of Trade Activities Affecting Small Business, will convene at this time.

I know the witnesses today are going to be very helpful to our committee and to the House of Representatives.

I will give a very brief statement at this time.

First of all, our ranking minority member, Mr. Williams, was coming in from Ohio today. He had to go home on business last night. He was on the 7:30 plane so he should be here any moment.

So as not to delay those who have been kind enough to come, we will begin.

New York is certainly a center of commerce, if not the center of commerce for this country, and of banking and other activities. So it is logical that we should begin this hearing here in New York.

We are looking at the question of small business failures. The Small Business Committee just sponsored a small business innovation bill just the other day in the Congress. We can report it has been successful.

The country is experiencing the worst economic conditions since the Great Depression of the thirties. In an attempt to strengthen the beleaguered economy, Congress last year passed the largest tax cut in the Nation's history and embarked upon what we call the economic recovery program.

Since then, there have been many misgivings about some aspects of that economic recovery program. The Federal Reserve Board, for example, has maintained tight money supply policies which limit as well as increase the cost of available investment funds.

It appears to many that these policies have canceled out any benefit small business and business generally could have gained as a result of the tax cut.

These recessionary times are reflected in the Dun & Bradstreet figures on small business failures. Their data for the first 23 weeks

of 1982 show that the number of business failures is 44.3 percent above last year's, and the 1981 figure reflects an increase of 110 percent over the 1979 statistics.

Worse yet, the 1982 failure rate is the highest rate since the failures recorded in 1933.

That litany of problems and misery that it causes is familiar to many. It is familiar to most. What we want to do in this hearing is attempt to determine the causes, and the extent of the damage done, particularly to our small businesses at this critical time in our Nation's economic history.

There is much more that I might say, but the purpose of this hearing is not to hear what I might say. I will comment from time to time as we move along.

We will call as our first witness Mr. Theodore Pierson. As I understand, Mr. Pierson, you are chairman of the board of Onondaga Supply in Syracuse, N.Y.

You have given us a statement. Without objection, it will be received into the record.

TESTIMONY OF THEODORE PIERSON, CHAIRMAN, ONONDAGA SUPPLY CO., SYRACUSE, N.Y.

Mr. PIERSON. Mr. Chairman, I've changed the statement a little bit. I have an updated corrected statement which I would leave with you.

Mr. LUKEN. All right. That amended statement will be received into the record of the proceedings of the committee.

You may proceed, Mr. Pierson, to summarize it, or to read it, or whatever you wish.

Mr. PIERSON. I would like to take a little of your time and go through it, since I am the first witness. I think you will hear many of these things again, but I will skip through as quickly as I can.

Mr. LUKEN. All right.

Mr. PIERSON. We are wholesale distributors of industrial supplies, floor covering materials, home appliances, and kitchen cabinets.

I have been a director of a number of small businesses and while I have retired from active management, I am in very close touch with customers and suppliers who are coping with today's problems, and you have already stated what some of those problems are.

I am also a member of the Governor's Small Business Advisory Board for New York State, so I receive a lot of input from small business people.

Your investigation of the disastrous effects of high interest rates is really timely.

The newspaper tells you the story. This is last night's Syracuse paper. The headline, front page "Budget Criticized by Economists. Interest Rates Won't Be Affected by Inadequate First Step." That is sad news indeed for the small business community if that is true, because we have been waiting a long time for something that would affect small business.

The Dun & Bradstreet reports are alarming; the highest rate since the Great Depression. And I will quote from that news story:

One economic analyst attributed the large number of failures to prolonged high interest rates that have hit small- and medium-sized businesses especially bad. These businesses pay above the primary rate to borrow money.

I showed this to the president of one of our local banks on the plane down to New York a couple of days ago, and he skimmed through it and he said:

You are not stating that hard enough. It is a significant amount that they pay. There are extra points added to the prime rate, compensating balances required, and it really approaches usury.

I clipped a piece out of this morning's local paper in which a real estate man, the leading real estate firm in Syracuse, is working on some loans for some new construction, and he says:

Lenders have set an interest rate of about 2 points above the prime lending rate, not at 16.5 percent. Moreover, Egan said, banks typically require borrowers to leave large compensating balances in accounts as construction loans are drawn. Every time we went to borrow a dollar, it would come out to about 60 cents.

An interesting observation which ties into this hearing.

Starting in 1930, I spent 3 years with a big business. I learned first-hand how the Great Depression affected management, labor, finance, and politics. New social programs were developed by the Roosevelt administration to make another Great Depression impossible. Over the years you have seen these social programs expanded and used so that human suffering in a recession was at least reduced.

But these socially beneficial props to our economy created through deficit financing a situation where we paid the bills with inflation and high interest rates which prevented our economy from making the necessary adjustments when they should be made. The old tools in the thirties were deflation, lower prices.

In my first 3 years of employment, my pay was reduced consistently every year until I got down to $22 a week, as a graduate engineer.

Lower labor costs, lower interest rates—they just don't work today.

Government grants, unemployment insurance, administered prices, price supports, and high interest rates are just a few of the props that are the aspirin and the Band-aids used to solve our problems with more inflation.

Apparently the only tool that our Government has found to cut inflation seems to be control of the money supply and high-interest rates. This has finally created an unnecessary recession and started to cut inflation in the most painful way. It almost seems the system rewards those to whom we have exported our dollars, such as the OPEC countries, who can then reinvest in the United States at exorbitant rates and at the expense of business people who must pay exorbitantly for the use of that money.

Obviously the true cure for inflation is elimination of the Federal deficit. Congress must one day address this problem with the same vigor with which we small business people must address a deficit in our business. It is not popular to attack deficits. It cannot always be done by raising prices or taxes.

But that is not the purpose of this hearing. Deficits and inflation are other subjects. I mention these because they helped create the high interest problem which I will address.

Unfortunately the high interest tool that the Federal Reserve Board is using to cut inflation is counterproductive even to our Government in that it increases deficits and further fuels inflation.

When I discuss high interest rates with some of our State officials, discussing the same subject, I could see they were sympathetic but they did not really grasp what interest rates of 16 to 20 percent mean to a businessman. So here are some facts I use about one small business to make the point.

This business has a $25 million annual sale, employs about 125 people, net worth of about $3.5 million. It has a long-term profitable record enabling it to borrow at prime. This business expanded substantially in the last 10 years and, since it is capital-intensive, borrows today about $3.5 million. About 60 percent of this is in bank loans. If business had been good and profitable in the last several years, much of this would have been repaid.

In 1981, interest which skyrocketed in the last 2 years was up over the high of 1980 for this company by about $100,000 to nearly $600,000. Here are some comparative figures:

In 1980, net profit was one-tenth of 1 percent of sales. Interest cost was 1.8 percent of sales. In 1981, there was a net loss in the business of two-tenths of 1 percent of sales. Interest cost was 2.1 percent of sales. That is how excessive interest impacted on our local economy.

And here is what interested our New York State officials. In January of this year this company laid off seven good employees, people that were needed, to offset the loss; seven good jobs are gone, seven people are drawing unemployment pay, and that is just part of the cost of high interest rates.

You might ask why this company could not reduce its loans to save interest. When the company expanded, money costs of 6 to 8½ percent were considered high. Those costs doubled and tripled, wiping out any possibility of profit. An expanding business cannot service customers with reduced inventory. You cannot close a key sales office. Collections are more difficult because your customers have the same problem you have. So you can see that the company was locked into these loans over which they had no control.

I want to emphasize this: The small business has no control today over the interest rate it must pay for loans it must keep. As the figures show; all chance for profit is wiped out.

Most small businesses do well to return a modest profit on investment. Very few can earn the equivalent of today's prime rate of 16½ percent. A business that does not have to borrow can survive by accepting a small return on investment. One that borrows must lose. In fact, most small business today would be better off if they could turn their assets into cash and invest in Treasury notes or a money fund. The 12- to 15-percent return without working and minimal risk would be a welcome relief.

The company could invest $3.5 million in a good money fund and earn about $½ million instead of losing over $50,000.

Small business people are optimists. They must be to survive. They hope this situation will change and they will recover. But if this same high interest medicine is continuously used to cure the ills in our economy, many will take their cash and walk away. It is happening now.

I have spoken to several people who have given up or gone bankrupt, and might have testified here. But people don't like to talk about their failures.

One former Oldsmobile dealer I talked to opened in June 1970 with 64 cars, had a floor plan credit line to pay for those cars of $180,000 at 5½ percent interest. He went bankrupt in August 1981. Now, high interest was not the entire reason, but look at this comparison.

August 1981, 64 cars on a floor plant at $640,000, at 22½ percent interest. The cost of his cars more than tripled, his interest rates more than quadrupled. That is a real threat to survival.

We all are aware of the sad state of the automobile industry. Just think how interest rates have pushed up the cost of building and selling cars, and then through the high cost of credit taken a lot of potential customers right out of the market. The auto industry has turned around to meet the threat and challenge of overseas competition. Can it also overcome the impact of high interest, credit restrictions, and the artificially high value of the dollar that invites more foreign competition?

I had a handful of news stories here, but you have seen them, and read the same stories.

But I would like to focus on one point that becomes apparent right now. The dollar is strong. And I have always said, boy, it is great to be in a country with a strong dollar. But just think what it means to us today. The car industry, many of our own industries, many of the things we sell, are suffering from imports. We try consistently to sell American. We saw our radio business disappear, we saw a lot of our television business disappear to foreign competition. A strong dollar, 20 percent higher than it was recently, means that every foreign competitor is coming into this country at 10 percent lower. We are throwing that burden onto the car industry and every other American industry.

You don't need many more examples. At President Reagan's recent summit meeting high interest rates were the concern of world leaders. Secretary of the Treasury Regan is concerned. And I will say that the stories the last few days are remarkable in that regard, in the turnaround of the Secretary of the Treasury's feelings regarding interest rates and the function of the Federal Reserve Board.

On June 15 the Associated Federal Press reported a broad market decline

> * * * attributed to interest rate worries based on the Federal Reserve larger-than-expected increase in the money supply, indicating no easing in the Federal credit policy.

On June 17, Associated Press reported the highest failure rate among commercial banks since 1942 due to "a combination of the recession and a prolonged period of high interest rates finally having"—and I emphasize this—"an effect on the ability of borrowers to repay loans."

Only some very big businesses seem able to borrow today without regard to interest rates. With 16½ percent prime, it is hard to see how Gulf Oil can commit $5.1 billion to acquire City Service.

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I wrote out all 10 digits in that figure because in Government circles billions seems as common as millions, but they are 100,000 times larger.

Could it be that a few cents in our gasoline costs can generate these funds, or is big business immune to high interest costs?

Small business is highly competitive today. I have never seen fiercer competition or more rapid developments in marketing. As a supplier to the auto industry, we are told that extra discounts are necessary so they can survive. We just got a letter saying, "We expect a 2-percent rebate on our purchases from this point on." And our automotive customers that we supply are very important to us.

Our suppliers encourage us to reduce our margins to create more business, while our bankers tell us to sell more profitably so we can get credit and pay the high interest rates. We are in a squeeze as never before.

Now, why do high interest rates persist?

Attached is an article from U.S. News & World Report of May 24, 1982—I have a copy that I will leave with you—"Why Interest Rates Stay So High." It is good reading. It focuses on real interest rates.

Since World War II, real interest, that is the real earnings of money, have averaged between 2 and 3 percent. Real interest is calculated by subtracting inflation from the actual interest charged. It seems reasonable that if someone loans you money, he should receive the benefit of inflation while you are using the money. But today inflation is way down, interest rates stay high or go higher. Where is the control? Is this equitable?

Apparently new factors have crept in.

The chart, "Anatomy of High Interest Rates," on the second page of this article in U.S. News, tells the story. When it was prepared, 3 percent went to real interest and 7 percent to then current annual inflation, which is now down, or a total of 10 percent out of 16 percent. Where did the other 6 percent creep in? It insures the lender against fear of inflation, risk of long-term changes, and protection against wild swings in interest which we surely have had.

Are not those factors which the Federal Reserve Board should control? Are we being charged for risks that our own Government creates and can control?

I am not well trained in economics. I don't really understand how interest rates are established. But I suspect this is something less than free competition and choice. I know it is in our case.

It seems the system has evolved that protects the lender more than the borrower, who has no choice but to pay today's rate or go bankrupt. For nearly 200 years of American democracy we lived well and accommodated to a commonly accepted definition of usury at 6 percent. As a young man I seem to recall savings banks paying as little as 1 percent or 2 percent.

About 10 years ago, our customers began to tell us that their bankers were telling them to incorporate because personal loans were limited by law to 6 percent, and then to 8½ percent. Money was not available at that rate. So they had to incorporate, and then pay the higher rate allowed on corporate loans.

Then the variable rate, and this is the culprit, loans became the practice—tied to a varying prime rate so that once a business made a loan it lost control of the rate that might be demanded. I can tell you from personal experience that when you buy a building and finance it with a variable rate loan at 7½ percent, and when we did this several years ago we were sure that rates would never go very much higher because we thought that was high. You are in deep trouble with no escape when it goes to 20½ percent. You cannot pay off the loan, but you have to absorb the losses. I thought it was a tax shelter, but I did not think it was a real money loser.

Small business has bargaining power in almost everything that it does except interest rates. That must be corrected, Mr. Chairman. We need some help, protection from the Government. And I am against a lot more regulations. I have testified time and again for less regulation; let the marketplace decide. But in a marketplace there has to be freedom. You have to be able to come in and look at the merchandise and buy it or not buy it.

Now, we saw in gasoline, people went to the gas station when gas got to a certain point, they just could not drive so much. Maybe they had two cars and went down to one. I know there are a lot of places I don't go that I would have gone several years ago. You have a choice. But when you are in the bank and you sign that note and it says prime, or 1 percent or 2 percent above prime, you are stuck because you have spent the money and there is no place else to get it.

Now, in my prepared statement there is a chart prepared by Dr. Robert Freedman, a friend of mine, a professor of economics at Colgate University. He shows the rate from 1971 through 1981 on U.S. Treasury bonds over an 11-year period, going from 6.2 percent up to 14 percent. Then he shows the Consumer Price Index, which had a low in that period of 3.3 percent and a high of 11.3 percent, down to 6 percent in 1981, for which we are grateful.

The real interest rate in those 11 years—well, let's eliminate the 11th one. Let's take in the 10 years, 1971 through 1980, real interest ran from a high of 2.9 percent to a negative of 3.4 percent. In other words, some years people that loaned out money did not even get back their inflation. They lost as lenders. So I don't blame them for trying to protect themselves. But I blame somebody for overprotecting them a little bit.

Remember, those figures I gave you—minus 3.4 to 2.8, 1981, 8 percent real interest rate. And believe me, it is higher now, because inflation is down, and rates are still up.

Please note that in this chart real interest rates are based on the difference between return on our best investment standard—I think you will agree—10-year U.S. Treasury bonds, and the Consumer Price Index measure of inflation. The figures you have.

The high interest problem must be addressed. It falls heavily on the private small business sector, which has no place to retreat except withdrawal or bankruptcy; on the individual whose credit purchases have built and supported our economy, giving Americans the highest standard of living in the world. I have had the pleasure of traveling to other countries, and the things we take for granted that we have bought with easy credit, most of our neighboring countries really envy, and frankly, they built our businesses.

The Federal Reserve Board takes credit for controlling our money supply and thus our interest rates. To get this far out of balance they must be doing something wrong.

We are concerned about windfall profits. What a windfall this must be to the OPEC countries, among others, who are reinvesting the money they have gouged from us at these unconscionable interest rates and are even gobbling up American banks.

If you pardon a personal observation, I do have some funds invested and earning a high return. I like that. But it embarrasses me because I know what the cost is to someone. And I cannot forget the biblical injunction against usury, and that has not been repealed, and hasn't been changed by acts of our various State legislatures.

This country needs an understandable coherent money policy which will bring the so-called prime rate down to historical real interest plus inflation in a stated period of time. We cannot stand a weekly change in course.

I am told that money will go overseas if American rates go down. Where will it go? No other country has the financial stability, the capacity to pay, and the financial needs to absorb the available funds. Let's become Yankee traders again in the real world.

I want to depart for a moment to tell you that I don't think anybody can, with high interest rates, compete with this country for these worldwide funds that are invested, because you cannot trust these other countries.

There is a big business in Syracuse bought by a French concern. I am very friendly with these people. I said, "How come you folks bought this business?" They gave me a very simple answer. They said:

> We have a fine business in France, but we have a Socialist government and a Communist work force. We are investing in the United States because we think it is the only stable place in the world that we can invest today.

The time is now to bring our Federal Government spending down to an affordable level, to give the Federal Reserve Board the task of bringing our financial system under control, to put America back to productive work. Small business will help if it has the opportunity.

[Mr. Pierson's prepared statement with attachments follow:]

PREPARED STATEMENT OF THEODORE PIERSON, CHAIRMAN, ONONDAGA SUPPLY CO., SYRACUSE, N.Y.

I am Theodore Pierson, chairman of the board of Onondaga Supply Co., Inc. of Syracuse and Albany, New York, wholesale distributors of industrial supplies, floor covering materials, home entertainment products, home appliances, and kitchen cabinets. I have been and am a director of other small businesses. While I am retired from active management, I am in close touch with customers and suppliers who are coping with today's businesses problems. I am also a member of the Governor's Small Business Advisory Board for the State of New York, which gives me good input from small business people.

This committee's investigation of the disastrous effects of high interest rates on small businesses is most timely. Dun and Bradstreet has just reported 532 business failures in the week ending June 11; the highest rate since the Great Depression, and up 70.5 percent over last year. UPI reports, "One economic analyst attributed the large number of failures to prolonged high interest rates that have hit small and medium sized businesses especially hard. These businesses pay above the prime rate to borrow money."

Starting in 1930, I spent 6 years with a big business and learned first hand how the Great Depression affected management, labor, finance, and politics. New social programs were developed by the Roosevelt administration to make another Great Depression impossible. Over the years you have seen these social programs expanded and used, so that the human suffering in a recession was at least reduced.

But these socially beneficial props to our economy have created, through deficit financing, a situation where we are paying the bills with inflation and high interest rates which present our economy from making necessary adjustments. The old tools like deflation, lower prices, lower labor costs, lower interest rates just don't work. Government grants, unemployment insurance, administered prices, price supports, and high interest rates are just a few of the props that are the aspirin and band-aids that keep solving our problems with more inflation. So the only tool that our government has found to cut inflation seems to be control of money supply and high interest rates which have finally created an unnecessary recession and started to cut inflation in the most painful way.

It almost seems that the system rewards those to whom we have exported our dollars, such as the OPEC countries who can then reinvest in the United States at exorbitant rates, and at the expense of business people who must pay exorbitantly for the use of that money.

Obviously, the true cure for inflation is elimination of the Federal deficit. Congress must one day address this problem with the same vigor with which we small business people must address a deficit in our business. It is not popular to attack deficits but it is essential in both business and government and it can't always be done by raising prices or taxes. I realize that deficits and inflation are not the subject of this hearing but I mention this because they are a factor in the high interest problem which I will discuss. Unfortunately the high interest tool that the Federal Reserve Board is using to cut inflation is counterproductive even to the government, in that it increases deficits and further fuels inflation.

When I discuss high interest rates with some of our state officials, I could see that they were sympathetic, but they did not really grasp what interest rates of 16 to 20 percent mean to a businessman. So I used this example from one small business to make a point.

This business has about $25,000,000 in annual sales, employs about 125 people, and has a net worth of about $3,500,000. It has a long term profitable record enabling it to borrow at prime. This business expanded substantially in the last decade, and since it is a capital intensive business, borrows today about $3,500,000. About 65 percent of this borrowing is bank loans.

In 1981, interest, which has skyrocketed the last 2 years, cost the company an additional $100,000 over the high of 1980, rising to nearly $600,000. Here are some comparative figures: 1980: net profit 0.1 percent of sales, interest cost, 1.8 percent of sales; 1981: net loss 0.2 percent of sales, interest cost, 2.1 percent of sales.

Here's how that affected our local economy: In January 1982, the company laid off seven good employees, people that were needed, to offset the loss. Seven good jobs gone, seven people drawing unemployment compensation, just part of the cost of high interest rates.

You might ask why the company could not reduce its loan to save interest. When the company expanded, money cost of 6 to 8½ percent was considered high. These costs doubled and tripled, wiping out the possibility of profit. An expanding business can't serve its customers with reduced inventory. You can't close a key sales office. Collections are more difficult because your customers have the same problems you have. So you can see that the company is locked into necessary loans over which they have no cost control. As the figures show, all chance for profit is wiped out.

Most small businesses do well to return a modest profit on investment. Very few can earn the equivalent of today's prime rate of 16½ percent. A business that does not have to borrow can survive by accepting a smaller return on investment. One that borrows must lose. In fact, most small businesses today would be better off if they could turn their assets into cash and invest in Treasury notes or a money fund. The 14 to 15 percent return without working, and the minimal risk, would be a welcome relief.

The company we reviewed, for instance, could invest $3,500,000 in a 15-percent money fund and earn over $500,000 instead of losing over $50,000.

Small business people are optimists. They must be to survive. They hope this situation will change, that they will recover. But if this same high interest medicine is continually used to cure the ills in the economy, many will take their cash and walk away. It is happening now.

I have spoken to several people who have given up or gone bankrupt and might have testified here. But people don't like to talk about their failures.

One former Oldsmobile dealer I talked to opened in June 1970 with 64 cars and a credit line of $180,000 at 5½ percent interest. He went bankrupt in August 1981 with 64 cars on a credit line of $640,000 at 22½ percent interest. The cost of his cars more than tripled; his interest rates more than quadrupled. That is a real threat to survival.

We are all aware of the sad state of the automotive industry. Just think how high interest rates have pushed up the cost of cars, the cost of marketing, and then, through the high cost of credit, taken a lot of potential customers right out of the market. The auto industry is meeting the threat and challenge of overseas competition. Can it also overcome the impact of high interest, credit restrictions, and the artificially high value of the dollar that invites more foreign competition?

You really don't need more examples of how disastrous high interest rates can be. You read the same newspapers I do. At President Reagan's recent summit meeting, high interest rates were the concern of world leaders. Secretary of the Treasury Regan is concerned. On June 15, AP reported a broad market decline "attributed to interest rate worries. . ." based on the Federal Reserve's larger than expected increase in the money supply indicating no easing in the Fed's credit policy.

On June 17, AP reported the highest failure rate among commercial banks since 1942 due to "a combination of the recession and a prolonged period of high interest rates finally having an effect on the ability of borrowers to repay loans."

Only some very big businesses seem able to borrow today without regard to interest rates. With a 16½ percent prime rate it is hard to see how Gulf Oil can commit $5,100,000,000 to acquire Cities Service. Could it be that a few cents in our gasoline costs can generate these funds, or is big business immune to high interest costs?

Small business is highly competitive today. I have never seen fiercer competition or more rapid developments in marketing. As a supplier to the auto industry we are told that extra discounts are necessary so that they can survive. Our suppliers encourage us to reduce our margins to create more business while our bankers tell us to sell more profitably so we can get credit and pay the high interest rates.

Why do high interest rates persist? Attached is an article from U.S. News and World Report of May 24, 1982 entitled "Why Interest Rates Stay So High." It is good reading. It focuses on real interest rates. Since World War II the real interest, that is, the real earnings of money after inflation, have averaged between 2 and 3 percent. Real interest is calculated by subtracting inflation from the actual interest charged. It seems reasonable that if someone loans you money he should receive the benefit of inflation while you are using his money. But today inflation is way down and interest rates stay high or go higher. Where is the control?

Apparently now factors have crept in. The chart "Anatomy of High Interest Rates" in U.S. News tells the story. When it was prepared, 3 percent went to real interest and 7 percent went to the then current annual inflation, for a total of 10 percent out of the current rate of 16 percent. The other 6 percent insures the lender against fear of worsening inflation, risk of long term changes, and protection against wild swings in interest rates. Are not these the factors that the Federal Reserve Board should control? Are we being charged for risks that our own Government creates and can control?

I am not well trained in economics. I don't really understand how interest rates are established, but I suspect that this is something less than free competition and choice. It seems a system has evolved, that protects the lender more than the borrower.

For nearly 200 years of American democracy we lived well and accommodated to a commonly accepted definition of usury at 6 percent. As a young man I seem to recall savings banks paying as little as 1 or 2 percent.

About 10 years ago, our customers began to tell me that their bankers were telling them to incorporate because personal loans were limited by law to 6 percent, and then to 8½ percent. Money was not available at that rate, so they had to incorporate and then pay the higher rate allowed on corporate loans. Then variable rate loans became the practice, tied to a varying prime rate so that once a business made a loan it lost control of the rate that might be demanded. I can tell you from personal experience that when you buy a building and finance it with a variable rate loan at 7½ percent you are in deep trouble with no escape at 20½ percent.

I have attached a chart prepared by Dr. Robert Freedman, professor of economics at Colgate University. Please note that in this chart real interest rates are based on the difference between return on our best investment standard, 10-year U.S. Treasury Bonds, and the Consumer Price Index measure of inflation. For 10 years, starting in 1971, real interest was unusually low, actually negative in 3 years. But in 1981 it exploded, and if something is not done fast with inflation going down and the prime rate going up in 1982, we are in for real trouble.

This is the problem that you must address. It falls heavily on the private small business sector which has no place to retreat except withdrawal or bankruptcy, on the individual whose credit purchases have built and supported our economy, giving Americans the highest standard of living in the world.

The Federal Reserve Board takes credit for controlling our money supply and interest rates. To get this far out of balance they must be doing something wrong.

We are concerned about windfall profits. What a windfall this must be to the OPEC countries, among others, who are reinvesting the money they have gouged from us at these unconscionable rates of interest and gobbling up even American banks.

This country needs an understandable, coherent money policy which will bring the so-called prime rate down to historical real interest plus inflation in a stated period of time. We can't stand a weekly change in course.

I am told that money will go overseas if American rates go down. Where will it go? No other country has the financial stability, the capacity to pay, and the financial needs to absorb the available funds. Let's become Yankee traders again in this real world.

The time is now to bring our Federal Government spending down to an affordable level; to give the FRB the task of bringing our financial system under control; to put Americans back to productive work.

[In percent]

Year	U.S. Treasury bonds 10 year [1]	Consumer Price Index annual percent change [2]	Real interest rate
	A	B	A−B
1971	6.2	4.3	1.9
1972	6.2	3.3	2.9
1973	6.8	6.2	.6
1974	7.6	11.0	−3.4
1975	8.0	9.1	−1.1
1976	7.6	5.8	1.8
1977	7.4	6.5	.9
1978	8.4	7.7	.7
1979	9.4	11.3	−1.9
1980	11.5	[3] 11.1	.4
1981	14.0	[3] 6.0	8.0

[1] Economic Report of the President for 1981, p. 310.
[2] International Economic Conditions (FRB-St. Louis) July 1980, p. 67.
[3] Economic Report of the President for 1981, p. 295, table B55.

Analysis

Why Interest Rates Stay So High

Budget deficits aren't the only culprits. Inflation jitters, heavy loan demand also are holding up money costs—and plaguing policymakers.

Now that inflation is cooling off, why aren't interest rates dropping?

President Reagan tried on May 12 to talk bankers into lowering rates by telling them there is no reason for lenders to charge as much as they do. Later, he told reporters rates are high because "money markets are not convinced" the government will stand fast against inflation and will curb spending.

Other Washington policymakers and money experts blame high rates on the huge federal budget deficit. Their remedy: Reduce the red ink.

But will presidential jawboning or congressional budget action alone cure the economy's interest-rate ills? Increasingly, the answer appears to be: "No." Other factors besides high deficits are also working to hold high the cost of borrowing.

Investors' fears. The biggest reason interest rates have not fallen from their lofty levels is the investment community's fear that even though inflation is easing it has not yet been tamed.

Aggravating these worries are doubts that the Federal Reserve Board will continue to keep the lid on the growth of the money supply.

Wild ups and downs in the financial markets are another factor. Since late 1979, interest rates have been on a roller coaster, making investors nervous about the future.

Add to these reasons brisk demand for short-term credit by both business and government and the phase-out of interest-rate ceilings on savings accounts, and you have added pressures for high rates.

Why are these factors holding interest rates up? One starting point is the anatomy of interest rates themselves as put together by investment bankers and lenders. Interest rates are essentially a form of rent—the price that borrowers must pay lenders for the use of their money. This "rent" must be sufficient to cover the costs or risks of providing the funds, plus an acceptable profit.

Investors and lenders are usually content to earn a profit equal to the average productivity gain for the overall economy. Historically, this rate has averaged 2 to 3 percent annually.

Added to this core rate is a risk premium with several components.

The first part reflects the creditworthiness of the borrower and the life of the loan. The extra risk is negligible for highly rated borrowers or for short-term loans, which last for several years or less. But, as a rule, the difference between short-term rates and yields on mortgages and bonds with terms of 10 to 30 years has been 1 to 2 percentage points. Small businesses, often considered more of a risk than big companies, frequently find an additional 1 to 3 percentage points added to their loan rates.

High inflation tacks another component onto the risk premium in order to offset the anticipated decline in the dollar's purchasing power over the life of the loan. This inflation premium escalated steadily during the past decade, generally matching the trend in consumer prices. It was just over 3 percent in 1972 and is now considered to be in the 7 percent range.

Together, the normal profit rate and the risk premium suggest that the long-term interest rate for top-flight borrowers currently should be no higher than 12 percent. But corporate bond rates are hovering at 15 to 16 percent.

Why? Economists say that this 4 percent difference represents two relatively new risks—volatility and fear.

The volatility component made its debut in October, 1979. That's when the Federal Reserve stopped trying to control the growth of the money supply by forcing interest rates up or down. Instead, the Fed began to focus directly on the supply of available credit itself. As a result, interest rates automatically gyrated whenever the money supply changed.

Investors, therefore, began to demand protection from wide swings in rates. The volatility premium, experts say, appears to have added at least 2 points to interest rates.

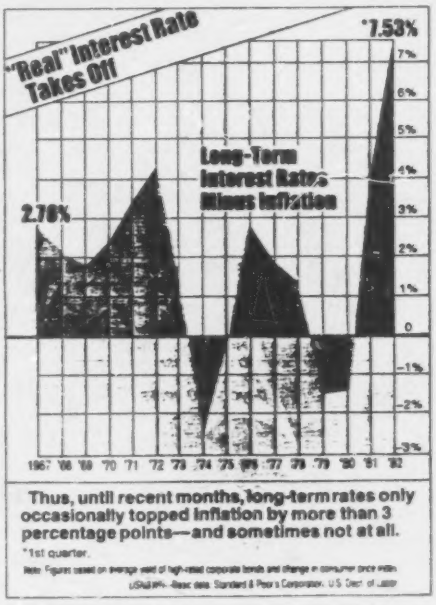
Placating lenders. The so-called fear premium is the price that borrowers must pay to quiet lenders' qualms about economic policy.

What rattles investors so?

Some are afraid that budget deficits that exceed 100 billion dollars will overwhelm the money markets, especially at a time when the Fed is keeping a tight rein on the money supply. An even greater number, however, are afraid that the Federal Reserve will loosen its grip and permit growth of the money supply to get out of hand and reignite inflation.

"It's a case of not knowing what will happen, and the financial markets hate uncertainty," explains Allen Sinai, chief economist for Data Resources, Inc., in Lexington, Mass. "Investors are unable to make long-term decisions."

Count in the current fear



Thus, until recent months, long-term rates only occasionally topped inflation by more than 3 percentage points—and sometimes not at all.

*1st quarter.

Note: Figures based on average yield of high-rated corporate bonds and change in consumer price index. Actual data: Standard & Poor's Corporation, U.S. Dept. of Labor

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premium of about 2 percentage points and you get today's long-term rate for many borrowers of some 16 percent.

That's too high for most companies, especially if they see a chance that interest rates will drop in the near future. So, to raise the funds they need, these concerns have stepped up their short-term borrowings, a move that creates its own headaches.

The reason: When companies borrow short term, they go to banks. Banks in turn have had to borrow funds from each other and from big investors in order to meet the rising demand for shorter-term loans. With Uncle Sam borrowing more than ever, short-term credit is scarce and thus expensive.

At the same time, the supply of long-term money has been held down because interest-rate uncertainty has made investors reluctant to tie up their funds. Portfolio managers and individual savers alike fear that such investments will lose value if prices begin to spiral upward once more.

Instead, the inflation-savvy have chosen to put their dollars into money-market mutual funds that now yield 13 to 14 percent. To stem this savings drain, banks and savings institutions have had to offer higher rates for short-term deposits.

Together, the heavy demand for short-term credit and the increasing cost of funds helped push the prime lending rate—the interest banks generally charge their best customers—to 20½ percent last year. The prime now stands at 16½ percent. A 3 percent normal rate of interest and a 7 percent inflation premium account for only 10 percentage points. Thus, the volatility and fear premiums have added 6½ points to short-term rates, boosting them above the 16 percent rate for long-term loans.

Critics charge that the uncertainty premiums allow lenders to reap huge profits at the expense of borrowers, since the "real" interest rate—the nominal rate minus the inflation rate—is three times the normal rate of return. Some financial institutions are enjoying increased income, but others, including savings and loan associations, are paying more in interest to depositors than they are earning from their loan portfolios.

Analysts point out that savers, who are really the nation's ultimate lenders, are the ones pocketing the extra interest income. "People with short-term liquid assets such as shares in money-market funds are getting very high real rates of return," observes Michael Keran, an economist with the Federal Reserve Bank of San Francisco.

What will it take to convince the financial markets that a stable inflation rate of 7 percent or less is possible?

A substantial reduction in the budget deficit would be a good first step, it's agreed. Some economists would like to see President Reagan and Congress cut at least 50 billion dollars from next year's deficit and then try to reduce total red ink to 50 billion by 1985.

An even more important prerequisite for lower rates as far as the markets are concerned is assurance that the Fed will keep the brakes on money growth.

"No one believes the Fed can stay on its course," observes H. Erich Heinemann, an economist at Morgan Stanley, a New York investment banking concern. "Interest rates are high today not so much because credit demands are intense or because money is tight but because market participants fear easy money in the future."

A reversal? Many analysts maintain that sooner or later the central bank will revert to its previous policy of accommodating federal deficits by accelerating the money-creation process. Others say the Fed will succumb to increased political pressures to bring down interest rates before the fall elections.

A few fret that Paul Volcker will be replaced as chairman of the Fed's board when his term expires in 1983 and that his successor will ease up.

"The Fed has to stick to its guns the rest of the year before the market will be convinced," says Irwin Kellner, economist for Manufacturers Hanover Trust in New York. "At that point, the markets will take a more benign view, assuming of course that we get a budget compromise."

But even when interest rates do drop, money costs are not likely to slide to levels of the early 1970s.

For one thing, inflation has not been eradicated. Despite the decline in consumer prices in March, many economists are predicting that prices will advance by 6 to 7 percent during 1982 as a whole and by the same percentage next year. Several months of an improving inflation rate are not enough to make bankers and investors forget a decade of price hikes.

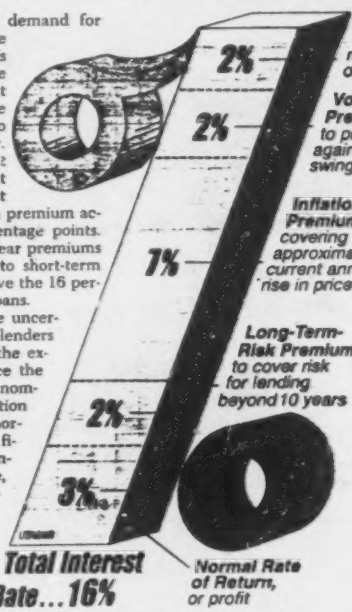
The volatility component of the risk premium will be present for some time to come, too, and the pent-up demand for long-term credit will establish a floor under corporate and municipal bond rates. Besides, banks and other financial institutions will continue to pay higher rates to savers than in the past. That's because Congress in 1980 ordered the phase-out of all rate ceilings on deposits by 1986. The resulting competition for funds can be expected to push the cost of credit up.

Thus, skepticism about inflation, the threat of triple-digit deficits, heavy demand for short-term credit, and escalating savings yields are working together to brake the long-awaited slide in interest rates. □

By PATRICIA M. SCHERSCHEL

Anatomy of High Interest Rates

What investment bankers typically include in figuring rate on long-term borrowing by a top-rated company today—


2%
2%
7%
2%
3%
Fear Premium, to protect against new outburst of inflation
Volatility Premium, to protect against wild swings in rates
Inflation Premium, covering approximate current annual rise in prices
Long-Term-Risk Premium, to cover risk for lending beyond 10 years
Total Interest Rate...16%
Normal Rate of Return, or profit

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Mr. LUKEN. Thank you, Mr. Pierson.

I think what you have done is given us a good overview, a good review of where we are with some of the background. It will help to prepare a foundation for the inquiry that we are making.

Let me ask just a couple of questions because we do want to give the other witnesses who are here an opportunity.

Do you have an idea as to what the interest rate might be where a small business could thrive? How far down does it have to come from the present levels?

Mr. PIERSON. From the present level, I would say that small business would have to learn how to pay real interest plus inflation. I think that is a place that you cannot say the man has money, you have to lend me your money and wind up with less a year from now. And I don't think small business can pay 10 cents more than that, and I don't think they should.

Now, where can we exist? We did well until interest rates hit in our own business about 8 or 9 percent. At that point, we found it difficult to make money.

Mr. LUKEN. You say real interest plus inflation?

Mr. PIERSON. Yes. Real interest being about 3 percent, and inflation——We would have to live with whatever it is.

Mr. LUKEN. Your chart shows a real interest rate in 1981 was 8 percent.

Mr. PIERSON. That is an artificial rate. That is a distortion. There has never been a rate like that.

Mr. LUKEN. Isn't that the problem? Are we pulling ours up by our own bootstraps here?

Do you have a problem with definitions?

Mr. PIERSON. Yes, I think you are right.

Mr. LUKEN. What is your definition of real interest rates?

Mr. PIERSON. The real interest rate is the rate of interest less the cost of inflation.

Mr. LUKEN. We are sort of chasing ours around the barn, aren't we?

Mr. PIERSON. You are right. The difficulty is that probably that particular figure should be real interest plus a premium that we talked about, and the premium is what is distorting it.

Let me restate it: I would say that small business can afford the traditional real interest of something between 2 and 3 percent plus the cost of inflation, but we cannot afford the extras.

Mr. LUKEN. OK. That is what I thought you meant.

Mr. PIERSON. I am glad you brought that point up, because in going through this it got away from me entirely.

Mr. LUKEN. What is your feeling, do you have one, as to whether inflation really has been tamped down? Have we licked inflation? That would be too strong to say have we licked it. Do you think this is just a blip on the screen, or do you think we have relatively long-term trend in lowering inflation?

Mr. PIERSON. I personally think that inflation is coming under control now, but due to the wrong kinds of pressures. It is coming under control because people just cannot afford to spend money. And the first thing that happens is that the person who owns things that have to be sold has to sell them cheaper. And that reduced inflation.

Mr. LUKEN. Well, if that is the case, if we get a boom in our economy, inflation is going to be back up, isn't it?

Mr. PIERSON. It could happen. I am not expert enough to tell you that. Taking our own business, we are trying to do everything in a slimmer way, and it will be a few years before we are caught in the same overexpanded trap that we were in.

Mr. LUKEN. Let me ask you one other question and then we will get to somebody else.

Do you feel that the Congress and the President, either one or both, should be more involved in the policies of the Federal Reserve Board?

Mr. PIERSON. Well, if you look at where we are, their policies are creating a situation where we are paying exorbitantly for the use of money. I don't quite believe that we have to have a severe depression, which we are working on, in order to correct the problems of this country. I think people want to work; there are things to do; there are adjustments to be made, and many have been made. They are made under pressure.

For instance, we do quite a bit of business with the automobile industry in Syracuse. It happens that General Motors and Chrysler both have substantial plants there. When Chrysler was in trouble, the labor unions did make some wage adjustments which were essential to get them moving again. At the Syracuse plant, which is a prosperous Chrysler plant and a very well-run one, their labor people didn't go along with the adjustment because they were in pretty good shape.

I think the President and the Congress have to give us some leadership in biting the bullet and not letting this country get into inflation, not spending money unnecessarily, not letting it run away from us, not demanding so much from the Government.

Next year I will be receiving social security at the age of 72. I have been looking forward to it for a long time. But frankly, I don't think that I should be getting cost-of-living adjustments. Now, the people who need it, and I—at this moment, unless things get tougher, don't expect to need it. I made a deal. I put money in and I would be glad to get what I am entitled to. But I don't think I need a cost-of-living increase every year. I think some of those things we have to mutually agree we all have to help. I don't think it is just the Congress, just the President. I think it is us.

Mr. LUKEN. Well, I personally would enjoy discussing it with you at least all morning; perhaps the whole day.

We do appreciate you contribution and your responsiveness.

You can be assured it will shed some light on our deliberations and, hopefully, they will result in improvement in our policies, and, therefore, in the economic conditions.

Mr. PIERSON. Thank you, Mr. Chairman.

Mr. LUKEN. Mr. Snyder. Mr. Allen Snyder, former president of Allen Snyder, Inc. We would appreciate hearing from you, anything you would like to tell us.

TESTIMONY OF ALLEN SNYDER, FORMER PRESIDENT, ALLEN SNYDER, INC., NEW YORK CITY, N.Y.

Mr. SNYDER. I did not prepare a lengthy statement, but I think I represent a typical example of a small business failure, after some 30-odd years in business.

While I concur in a great many of the things that the previous gentleman has illustrated, I think I can give a more specific example in my own personal case as to what has resulted from conditions as they exist today.

I would just give you a few remarks to explain the nature of the business that we are in.

Textile converting is a business that soon will not be available at all due in large measure to high interest rates, economic conditions generally, and the loss of our markets to form competition.

The function of a textile converter, which is what I was, is to purchase raw materials and produce a finished fabric, primarily for garment manufacturers. The cost of raw materials is payable usually in 30 days, and the processing, which involves knitting, dyeing, finishing, is payable promptly, since it is labor. The time involved in the total processes is approximately 4 to 8 weeks. Therefore, considerable financing is required.

Further, fabrics are historically sold on 60-day terms requiring additional financing for this period.

In order to accommodate these lengthy financing costs, accounts receivable are assigned to factors or banks, and extensive borrowing is needed to pay for operations as well as inventory.

The cost of this money is usually 2 to 4 percent over the prime interest rates plus 1 to 2 percent of the gross sales as a cost for credit checking and handling of the accounts receivable, plus certain periods for collection, usually 10 days.

In simpler terms, this means we must pay almost 25 percent for the use of money. Adding these higher interest costs and competitive market creates an impossible situation. It becomes impractical for a small business, even with fairly substantial capital, to exist. Larger and well-financed costs are suffering as well.

Inventories to service our markets are difficult to maintain. The historical functions of the converter, to style new fabrics, for example, ability to change fabrics as fashion dictates, and service to our markets of reasonable deliveries, become impossible.

These conditions have caused many failures and are the reason for the erosion of a very substantial part of our industry.

The high interest rates, added to the restrictive bank requirements for borrowing, tight credit checking required by a generally difficult market, and numerous additional hidden costs by the banks, don't make it worth continuing business, even if we could manage financially.

I have only given you a general outline of the nature of our business and our industry. I would be happy to answer any questions or further discussions that you might care to make.

Mr. LUKEN. I don't think we asked you the details. What is your address?

Mr. SNYDER. 200 East 74th Street, New York City.

Mr. LUKEN. And your business was here in New York?

Mr. SNYDER. My business was here in New York.

Mr. LUKEN. How good were you in business, and when did your business terminate?

Mr. SNYDER. We have been in business since 1944.

Mr. LUKEN. Until when?

Mr. SNYDER. We were forced to make an assignment to creditors in March 1982.

Mr. LUKEN. When did you determine that the business wasn't going to be able to make it?

Mr. SNYDER. Well, my final determination was not really until the early part of this year, sometime in January or February.

Mr. LUKEN. Did you have a pretty good realization before that?

Mr. SNYDER. Well, my hope was that I would be able to survive this period, and with sufficient help. There are other factors that were involved. It is not really interest rates alone that caused the demise of our business. The largest cause, I would say, or one of the major causes, was the competition from overseas. The amount of garments and fabrics which are being imported, being produced overseas, is astronomical. We have lost, I would say, better than 50 percent of our market. The market that remains has become so competitive and so difficult that it just is no longer possible to stay in business.

Mr. LUKEN. Well, that is another area, of course, of vital concern to us in legislative matters.

We just passed some legislation through our committee yesterday with references to services, importation of services as distinguished from goods and products. Frankly, we didn't have time to consider it in depth, not that we have not considered the question in depth. So I mention it by way of example of the kinds of legislation which are being proposed and being proposed through the Congress.

Our big telecommunications bill, the Ma Bell bill you hear so much about, because there is so much riding on it, not only A.T. & T., but their big competitors, and the fact that the communications business may well be the largest of industries in the future, bigger than steel or possibly even bigger than oil. So that as we are addressing, in this little old telecommunications bill, we are talking about perhaps the most important economic piece of legislation that the Congress is going to be looking at.

And one of the questions of course—and Bell has mentioned it in its advertising is that if we put the restrictions on Bell, we are going to invite competition from overseas rather than provide opportunities for domestic competitors. Those are the kinds of questions that we have.

Would you want to add anything to that?

I am mentioning some related matters, not directly on your field, obviously.

Have you gotten into those questions as to whether our trade policies are equitable in this regard, or do you feel we should be more vigorous protecting our textile industry?

Mr. SNYDER. I think it is necessary to become more vigorous, because we are going to absolutely have no industry there if the current situation would increase or even remain as it is.

Studies have been made, and I am not really that well versed in some of the more economic studies that have been made relative to

the textile industry, and really can only talk of those that I am personally familiar with. But in the studies that I have read, the industry is labor expensive, which is the manufacturing of a particle primarily, we are in no way able to compete. We are technologically improving, and updating our production facilities here. We are improving in many areas that would make us competitive worldwide. Where the labor expensive products are involved. we are not even close. We are not, from what these studies indicate, not 10 years away, even with the production of fabrics, the technology involved in the making of yarn, fiber, the manufacturing of the fabrics themselves. While we are not really competitive, we are not that far away. If we are able to help with the interest and several of the other cost factors, then we are closer to becoming competitive. But the labor expensive areas, we are in no way, for many years, closer.

Mr. LUKEN. Principally, I assume it is a given fact that labor costs in places like Hong Kong are a good deal less.

Mr. SNYDER. Yes.

Mr. LUKEN. Of course, we are also suffering in the automobile and steel business, since our competitors overseas sometimes have not more advanced technology, but better use of available technology, than we do.

Mr. SNYDER. That is correct.

Mr. LUKEN. They also have more favorable Government policies.

Mr. SNYDER. Correct.

Mr. LUKEN. Which we would resist.

Do you have any comments on the questions we were discussing before on our Government policies, our Federal Reserve policies, our budget deficits affecting the high interest rates? What is your observation about those?

Mr. SNYDER. Well, I don't think we have decreased inflation to any sizable extent. I think that decreased figure is rather misleading. We are in a severe economic depression, which has caused a lack of business. It is not really that inflation is down. People just don't have the money. We have not brought anything down.

As the last witness pointed out, with the interest rates high, we just cannot exist and we have no more customers. There has not been a real inflationary decrease. Of course, our customers are manufacturers, not the consumer.

Mr. LUKEN. If small business is not making money, it is going to have to borrow money to survive, isn't it?

Mr. SNYDER. Exactly.

Mr. LUKEN. That is a factor.

Mr. SNYDER. Of course.

Mr. LUKEN. That is one of the counterproductive aspects of the recession, combined with the higher interest rates.

Mr. SNYDER. Right.

Mr. LUKEN. That creates a vicious circle.

Mr. SNYDER. That is exactly right.

Mr. LUKEN. Does the staff have any questions?

Mr. DALTON. Just one. What sort of interest rates could you handle in the fabric converting business?

You were saying you have about 120 days' worth of working capital needs, from the time you get your raw material to the time you actually sell your product and get the money for it.

Mr. SNYDER. That is correct. But what figure the market is able to associate would be most difficult to answer, because we are facing such a competitive situation. We might previously have been able to get along with a lower figure, but that is only one of the contributing factors. We have got a competitive situation of large vertical mills whose borrowing is under prime, or who have their own capital sufficient to finance that sort of situation. But historically, the converters functions are what is different from the large vertical mills. And our flexibility and our ability to service and move more quickly than large mills with big productions which they are committed to gives us the functions. It is more or less a fashion and service function.

We have been able for many years, as a 30-odd year history indicates to do that very well and profitably. And the passing on of interest costs was just one of our costs. There is nothing historically that has changed. We have also sold goods at 60-day terms and also been able to maintain a minimal kind of inventory. It was not large primarily because the fashion situation changed and it was costly to maintain.

To give you a figure of what would be tolerable now is very difficult to arrive at, because we now have a competitive situation. We have a recession. We have a competitive situation from the large mills where you haven't got a chance. If you are doing high fashion goods, designer-type fabrics, or designer-type garments, the price becomes unimportant. Then it doesn't make any difference whether the woman is going to spend $1,500 or $1,800 for a dress—if she spends $2,200, it has nothing to do with the issue. The issue is, can she spend that much money for a dress, and if she likes it, she will spend $2,200 just as readily as $1,800 or $2,000. But the bulk of our business is not that way. For the moderate or medium priced, I wouldn't know how to put a figure on what interest rate would be tolerable and acceptable and something we could pass on.

Mr. DALTON. What are the sources of your foreign competition: Korea?

Mr. SNYDER. Start with Japan and Hong Kong, Taiwan, Singapore, Korea, Sri Lanka, the Philippines, and now all of South and Central America like Guatemala and Brazil. It is an endless area. There is a great deal of part manufacturing down here, and then the goods are sent for manufacture overseas and come back here, avoiding the duties. I am not exactly familiar with the regulations—AO-7, I think—where it is partly manufactured here, cut here, sent overseas to Haiti to sew, returned here.

Mr. LUKEN. I believe there are virtually no restrictions on textile imports.

Mr. SNYDER. Well, there are multifiber agreements, et cetera, that are not really terribly effective.

Mr. LUKEN. But not limitations.

Mr. SNYDER. There are really no limitations.

Mr. LUKEN. We have some in footwear. I don't think they are working too well, but I don't think we have any in textiles.

Mr. SNYDER. Well, other than these, as I say, multifiber agreements. There are some restrictions, I think, on the amount of imports of garments in various categories. There is a regular traffic in the sale of licenses to import. Quotas, are really not too effective.

I mean it is so large now, and predicated on what was done last year, they are going to allow them only to increase a certain percentage this year. Well, it was so excessive before, it doesn't help us a great deal.

Mr. LUKEN. That is the frustrating thing about it. We can pass laws for free trade. They are supposed to provide reciprocity and fair trade. But in the actual execution of those laws, it doesn't work out that way.

Mr. SNYDER. No; it certainly doesn't.

Mr. LUKEN. Well, Mr. Snyder, we thank you very much for your indepth coverage of your situation, which I think will give us and give the committee a deeper grasp of the situation as it affects individuals. We appreciate your help.

Mr. SNYDER. Thank you.

Mr. LUKEN. Now, perhaps we could move on and ask the next two witnesses to come forward.

Our next two witnesses will be Mr. Citron, attorney for Mr. Snyder, and Mr. Sydney Platzer.

We will proceed apace here. We are still waiting for Mr. Williams. We are sure he is unavoidably detained. We will continue and we will ask Mr. Sydney Platzer and Mr. Cecil Citron, both members of the bar here in New York City, to appear.

Mr. Platzer, you are first on the list here. We will ask each of you to make your individual presentations in any way you feel comfortable with and the best way you think will be helpful to advancing the cause.

One thing I appreciate is the informality of this hearing. At least I am enjoying it. I think it will be fruitful. So we will continue on that basis.

Mr. Platzer, please proceed.

PANEL CONSISTING OF SYDNEY PLATZER; AND CECIL CITRON

TESTIMONY OF SYDNEY PLATZER, ATTORNEY, NEW YORK CITY, N.Y.

Mr. PLATZER. I have been practicing in the insolvency field in excess of 20 years. During that period of time and during approximately every year or so, I probably consult with or speak to about 100 or so companies which are in financial difficulty. I am focusing strictly on the representation of the company as oppposed to representation of a creditors' committee.

Not all of those consultations result in the demise of the company. Very often the company may rehabilitate itself within its own means.

Mr. LUKEN. You don't mean after filing?

Mr. PLATZER. No. I am saying it is possible for us to look at a company, consult with the management, and advise them to attempt certain cost-saving techniques which may not result in a filing, or may avoid a filing. Sometimes it is just working within the company, sometimes it is attempting an out-of-court settlement with the creditors to get rid of some of the trade debt. Sometimes it is consulting with the secured lender.

But there are a lot of causes for a company to be in financial difficulty, and companies are not only in financial difficulty during

high interest rate times, during time of depression. A company can be in trouble during time of prosperity. There are filings during time of prosperity. There are reorganizations during time of prosperity.

If we look at it, the company may have been started by untrained management, somebody who left a job and had an idea and thought he was going to be an entrepreneur, and the day he walked into his own company he decided he is not really working because he is the boss. So he puts on 3 or 4 aides he really does not need. He is probably not getting professional advice from management consultants, accountants, or an attorney who works with him, who can focus on his day-to-day problems. He usually talks to his attorney when it is too late.

He wastes a lot of money. He runs too many cars through the business, funds an executive office that looks like a living room, and he just does not have the need for it. It is for his own personal aggrandizement. It is not for the purpose of visiting customers.

But usually when a fellow goes into business, he has to borrow some money, and he goes to a lender, a bank, a factor. At that time he is presented with a stack of documents. They are printed forms. They tell him it is the usual document, and besides "We are never going to change this." So we are living by the golden rule, he who has the gold makes the rules.

The fellow signs away his life, gives him the inventory. He is not borrowing against the inventory but against the receivables. He gives them plant and equipment, a personal guarantee. And possibly if they are still not secure, with this beginning loan, they may ask him to pull some side collateral, like a mortgage on his house, maybe a CD, maybe some stock.

And now, after he has negotiated this arm's length transaction, and he has borrowed the money, he is in a position where he is dealing on a one-sided contract, because he went in borrowing at a particular rate and assumed turnover of inventory, assumed collections of receivables, and assumed that he was going to be able to meet that rate. But the rate is a variable rate, and he is in there, he has pledged everything he has. He has pledged all the assets of the business, and he has to deal with this variable rate.

If he is competent, if he has good professional help, he may be able to build it into his pricing structure. But if you have a markup as in some industries where the markup is limited simply by the nature of the industry, he cannot build it in. So you are going to hell in a basket, it is just going down fast, and there is no way to handle that. He falls behind his trade, paying off the secured lender, or attempting to meet the interest rates, and he is in trouble.

It is that fellow that winds up filing a chapter 11.

The nature of the business dictates the ability to handle the interest rate. A business that has a notoriously high markup, a luxury business, high-quality jewelry, they can handle a high markup. The printing trade, which I know very well, cannot handle a high markup. If they have to print cost effective for a magazine, they cannot increase their rate to meet their borrowing costs. They have to buy paper immediately. Paper terms generally are 30 days. They don't give them any time. If you don't pay that

30-day bill, you don't get any more paper on a large scale. The paper vendor, wholesaler of paper, is working on a 3- to 5-percent markup, buying it from the mill and shipping it. He cannot afford a loss. So he won't give you very long terms. He is paying for cost of money also, and he has to turn his money fast.

Now, you have a high labor charge in there. You have to pay your labor or the press doesn't run. If the press doesn't run, and you paid $1 million for that press, and it is not running 24 hours a day, you are not going to be able to pay your interest charges.

So it is a vicious cycle.

He walks to his bank, "How much can I get advanced on the receivables?" They give you some money and it goes out into the labor charge, the profit isn't there, and perhaps he is even building up a deficit.

So I have attempted to simplify the method by which a business starts to accelerate on a downward trend.

You can go to other industries where management problems are a fiscal plan, a projection of a plan, "What do I need? How much will I need? Can I get away with carrying less inventory?" Since that inventory is sitting in the back of the warehouse it is costing money every month. If you borrowed the money to buy it, and if it doesn't turn over fast enough, or if you are carrying an inventory you really don't need because it is too slow-moving, your interest charges are going to take you down.

The problem, as I see it, gets accelerated by the fact that this happens to a lot of businesses, because your receivable money comes in slow. If the receivable money comes in slow, you are not paying the loan down fast enough, the interest charges that you anticipated or projected are increased. If you are maintaining too much inventory, and your receivables are slow, it just becomes that much faster.

Then we get to the point where they walk into our office, or Mr. Citron's office, and they say "I am receiving some bank pressure." That is a euphemism that we hear, and it usually means "I am being strangled to death."

I am handling one situation now in the State of Pennsylvania in which a lender was in for $13.5 million on receivable and inventory financing. The company has approximately $20 million in receivables on the books. They are very slow paying. The reason is because the industry terms provide that the purchaser of this particular vendor's product may return unused portions. They have $17 million at cost inventory. When the lender felt insecure, there was a conference between management and the company, and the lender points to the documents that were signed on the initial loan and says, "Boy, when I feel insecure, that is a condition of default, so I would like to be out of here." Management says, "I cannot go out and get $13 million for you; I don't have it."

"Well, let's do it this way. We will take $800,000 a month." The company collects $1 million a month in receivables money coming in. At $800,000 a month, that leaves them $200,000 to take care of the average float of $11 million of trade debt. The summonses start to come in like rain.

The problem becomes accelerated by overreaction. If this lender had looked at it from a different point of view, and said "I want to

get down," but you cannot get down at $800,000 a month and expect the company to survive. But had they projected a better repayment schedule and had projected into the repayment schedule advances in slow periods—because in a slow period they are going to miss their payroll if they don't get advances—I think the lender would have a better opportunity to get out whole and the company would have an opportunity to survive.

That does not focus directly on the interest rate but it focuses somewhat beyond the interest rate in terms of what happens when the company cannot pay the interest rate.

That is pretty close to a typical example of an insecure lender. And it is possible, incidentally, for the lender to have a bad loan. The company lost money, but at the same time to accelerate the demise in trying to get out of the bad loan I think is an improper approach.

The additional effect of a lender who is not satisfied with a loan is that the lender really directly or indirectly controls the operation of the business in the form of determination of the policy, again controlling the purse strings of the company. This again really takes away from management the freedom to work their way out of the situation.

There is not, however, a solution to the problem that I see because the lender is lending money to make a profit. They are lending the money with the idea of getting repayment. They know they have to get repayment when they see the business going down.

The problem is overreaction and attempting to get repayment too quickly.

Mr. LUKEN. Mr. Citron, I assume——

Mr. CITRON. You assumed I would disagree with you; I know.

Mr. LUKEN. Mr. Citron.

TESTIMONY OF CECIL CITRON, ATTORNEY, NEW YORK CITY, N.Y.

Mr. CITRON. I have been at this a little longer than my colleague. Your subject is about as wide as a church door and as deep as a well.

I would like to center, however, upon the primary problem of: Do high interest rates cause insolvencies? I thought that was your main topic for today, with a few variations of course.

Mr. LUKEN. That is certainly part of it.

We also want to go into not only how the high interest rates impact upon small businesses, upon business, but the Federal deficits, whatever you may have to offer with relation to those questions.

We also want to get to the element of causes. But one of the principal considerations is how high interest rates impact some smaller businesses.

Mr. CITRON. Well, the usual speech that one makes when one is a debtor and you are addressing a group of creditors as to the basic causes for the debacle, or financial situation which the debtor finds itself in, are general economic conditions, which stripped would center about the fact that sales have diminished, costs have increased. We forget about mismanagement. And we add parenthetically that business usually has been undercapitalized.

Mr. LUKEN. That is hindsight, though, isn't it?

Mr. CITRON. Yes, because they don't come to us until the situation is pretty low. They forget at the beginning that they should have put more money in because they are borrowing from the banks and, as a result, they are going to have a fixed charge.

Now, money to me is no different from any other commodity. You are paying for the use of money. It is part of the inventory that you buy from the bank. Having acquired that inventory, you are going to pay for it. Unfortunately, it is comparatively high. And as a result, that becomes another charge, no different from the charges that you acquire elsewhere.

Let me state that I disagree with my friend in one respect. I think that any creditor who lends money—I am not feeling sorry for the banks—is entitled to as much collateral as he can get.

Our experience with the banks may be a little different from Mr. Platzer's. Without them, the business could not start. And no banker is going to take more collateral than he needs in an effort to stifle the operation of the business. No banker I know who is going to lend money will take an inventory lien and accounts receivable as collateral unless there is a very substantial loan predicated upon those assets.

In other words, if you just finance receivables, you have the fixed loan, as distinguished from buying the accounts when you factor the accounts.

If you want to borrow money against your inventory, he is going to give you an additional sum. Now of course that creates an additional charge.

Now, what happens ultimately when the business begins to go sour? All creditors begin to press. If there is an inventory lien, you are going to have difficulty getting credit, because the unsecured creditor has nothing upon which he can rely in the event this business does go sour.

So while I may not hold a brief for the banks or the oldline factors, most of whom today are a division or an affiliate of the banks, nevertheless they certainly are essential, at least in the soft goods field with which I am most familiar, so that without them we may just as well forget about the operation of the business.

Now, what happens? Unfortunately you have these fixed charges, and you buy your inventory, and you find that as a result of the diminution of sales, you may be saddled with this inventory. Your charges remain the same on the inventory. You must pay your bills; otherwise, you are going to be met with a raft of lawsuits. If your sales don't increase, your expenses in that aspect at least remain the same.

As a result, you buy less inventory. Your customer will buy just what he needs. You don't have the backup, because you are not sure you are going to dispose of it, and he will not buy more than he thinks he can sell.

Now, interest rates, as I said, constitute, as far as I am concerned, just another charge—important, certainly, but not the solid factor. Unless you can increase the sales, you are not going to make money. You have a fixed charge on your initial loan and, as a result, your business will gradually lose.

Now, when a debtor comes to you, we will assume he comes to you before he is in trouble, and you look at his comparative balance sheets and profit-and-loss statements, you will see that there has been a diminution in sales. Expenses, of course, go up. Your rent goes up, your labor goes up. I won't touch on the multiple employers pension program, because that, unfortunately, hits when you are ready to go out of business. But everything is going up, and your interest rates are going up. Unless you increase your sales to meet that, your profit margin won't go up. You try to incorporate all these figures in your sales price, and you cannot do it.

Mr. Snyder spoke about competition. You have it. You might be able to overcome that if you had sufficient sales.

Now, with regard to business overseas, of course there are many, many manufacturers here in the city who will buy the raw material one place, ship it out of the country to be made, and ship it back. There are customs charges, there are freight charges. They can still sell it for less than the fellow who makes it here. Certainly, there is nonunion labor in places like Haiti, Jamaica, and Puerto Rico, where they get a very substantial assist from the government.

Now, when you get into the field, we have found that instead of being known as the kiss of death, we try to act as surgeons and resuscitate a business.

Most of our practice deals with business. We don't do any negligence work, matrimonial or criminal work. We deal only with business, and the idea is to see and ask the primary question, "Assume your creditors gave you a moratorium for 6 months a year. Do you have a viable business? Worry about paying them back later?" Because we have found, especiallly today, that creditors will go along, they understand what is going on. The secured creditor is not ready to foreclose, because if we were to sell you out, he will sustain a substantial loss.

We find that the banks and factors are most cooperative. They will go along with the rest of the creditor body. But you must first determine whether the business is viable, no matter what they did.

The cliche is that when you file a petition for reorganization the court puts an umbrella over the business and nobody can touch you, even taxes. But then you begin to worry about cash flow. If your accounts receivable have been hypothecated, how do you get money with which to operate. Then you can work something out on a bootstrap operation, and pay out of the business, because you may be getting in cash all this time and paying none of your old debt, including the security creditor who will restructure his loan, has been our experience, to assist in keeping you in business, so that he can ultimately do something to recoup whatever he has involved in your business.

Creditors have been most cooperative, but I regret to say that despite that we find that the business must ultimately be liquidated. They just cannot make a go of it, despite the cooperation.

Now, the bankruptcy code today I think is without a doubt the most salutary statute as far as insolvency statutes are concerned.

Mr. LUKEN. You are speaking of business now?

Mr. CITRON. Only business. I am not dealing with the individual. I am not dealing with chapter 13.

Mr. LUKEN. I wasn't suggesting the laws with regard to individuals are good or bad. But your remarks are directly, strictly to business.

Mr. CITRON. Strictly to business. I think it assists; it stops everything from impinging on the continuance of the business. Frequently you find you can put it through.

Our judges, particularly in the southern and eastern districts of New York, are most sophisticated, most knowledgeable on the subject of business. You can get their fullest cooperation and assistance. Creditors today, especially in the soft goods field, are very sophisticated, and they know what is going on. There is no purpose in making certain that a business is dissolved, sell them out, and do what you can with them.

The provisions of the code relative to an orderly liquidation are most beneficial, because you find that if you can continue to operate, instead of having your piece goods and your goods in process, if you can convert that into finished goods and sell it, albeit at a price different from your customary price, at least creditors wind up with something.

Now, as far as interest rates are concerned, of course I would like to see them come down. I would like to see rents come down. I would like to see all expenses come down. The profit margin, the percentage margin, could remain the same, but that is impossible today.

How you would reduce interest rates I don't know, but obviously if they stay where they are. As Mr. Pierson pointed out, if you compare the profit and loss statements from 1 year to the next, especially when you finance receivables, whether by factoring or strictly financing, you will note the increase in the interest rate. Your margin of profit remains the same, your expenses may remain the same, but the interest keeps going up, and you cannot add that to your purchase price.

I am now talking of a small businessman.

We represent the Downtown Textile Credit Group which is an organization of textile people. And one of the problems is that you cannot continue this slow accretion to the interest rate with everything else remaining the same. If that could be diminished, your net profit, if there be such, would be modestly increased.

Mr. LUKEN. Let me interrupt you for a minute.

The gentleman on my left is the Honorable Lyle Williams, from Youngstown, Ohio. We don't have to have any further comment to that. Obviously Mr. Williams, from his origins, is aware of the recession or depression which exists in this country.

I might add for those who have not perhaps been informed, I am from Cincinnati, Ohio. Ohio, I believe, has the second highest unemployment rate in the country, right next to neighboring Michigan.

I can testify to the fact that conditions are not a whole lot better in southwestern Ohio than they are in northeastern Ohio, where Mr. Williams originates, but I would like to introduce him. He is the ranking minority member, that is, Republican. I happen to be a Democrat. It has never interfered with our pursuing the cause of, in this case, bettering the lot of the small business person in this country. We have been working together on this now for some

time. I am very honored to be able to work with him, and recognize him as a very eminent Member of the Congress and very valued member of our subcommittee and of our full committee.

Now, I took this opportunity to introduce Mr. Williams and to interrupt you, Mr. Citron. Let's continue our discussion. We can do it perhaps in a give-and-take fashion.

Mr. Williams, we have Mr. Platzer on the left, Mr. Citron on the right, both of whom are prominent members of the bar here in New York, and who have testified. They represent businesses and have had more than a passing acquaintance with the problems of businesses which might be in the insolvency razor's edge, counseling people who have economic problems, who have problems in their business, and representing them both before filing and, as Mr. Platzer pointed out, many times salvaging business so they don't fail.

Lyle, at this point, why don't you say whatever you want to say.

OPENING STATEMENT OF HON. LYLE WILLIAMS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. WILLIAMS. Well, I want to compliment the chairman first of all. I believe he has said it well. We are from Ohio and I believe we represent the good grassroot constituency of this Nation. I think we are closest to what is going on in this country. The information you are providing for us is essential as we try to make judgments on legislation or regulatory relief or whatever we are talking about as we approach the decade of the eighties.

I just have one question.

First, I apologize for being late.

Mr. LUKEN. Incidentally, Lyle is not a lawyer.

Mr. WILLIAMS. This is a true layman's question.

Youngstown, Ohio, went through a very serious economic crisis with the closing of steel mills. It made national news because of the great unemployment. The burden was placed on blue-collar ethnic workers, and so forth.

Just as members of your profession, and pulling from past experiences that you have had representing small businesses and others, are you frightened?

Mr. CITRON. Mr. Williams, the answer is yes. I think everybody is trying. Congress is trying. The President is trying, but I don't know the way out.

Mr. Luken asked the question earlier of other speakers what interest rate do you think would help. Any diminution would help, but is it possible?

Can you just pick on interest rates and say henceforth we are going to put a maximum throughout the country, assume that were so, and we can have a Federal usury law of, let's say 10 percent, arbitrarily, that is it?

The effect may be disastrous.

Mr. WILLIAMS. I get the impression sometimes we are all caught in a situation where we are just going day-by-day and hoping the end doesn't come 2 weeks from now or tomorrow or something like that. Are you sharing that?

Mr. CITRON. I am not quite so pessimistic personally. But when I see what we used to call the Momma and Poppa store—I assume both of you gentlemen are familiar with them—just about no longer exist in the city, that's impossible. Our rents are too high; they can't continue.

I have a great deal of experience in the men's wear field. At one point we represented most of the manufacturers in insolvency proceedings. They have just about vanished from the streets of New York; the department stores, yes; the larger chains, yes. But the individual retailer, is who I am speaking of. I am trying to think of a few. Some of the better ones, better-known stores, used to be in the Broadway area—Phil Kronfield——

Mr. WILLIAMS. These were family-owned?

Mr. PLATZER. Started that way, and grew larger.

Mr. CITRON. Rogers Peat is being run by an entrepreneur that is no longer Rogers Peat. He is doing very, very well.

If you read today's New York Times, the summer sales have slashed prices even more than they usually did at this time of the year to dispose of inventory. They are not buying too much because you may be aware of the fact, even some of the manufacturers have gone. They just cannot manage with the expenses as they are.

I am afraid, because I don't know. I am a depression baby—not quite, a little bit before. But I don't see the solution.

Mr. WILLIAMS. You are really frightening me if you don't see the solution, working with these people.

Mr. CITRON. We work with the people. I see a great deal of cooperation.

Mr. WILLIAMS. Are there no one or two things you can put your fingers on?

I just heard the end of your testimony, and it just seemed like a maze of different things that were destroying this entity. Is that a fact?

Mr. CITRON. I don't know.

Mr. PLATZER. In response to that, I think there is something different in each one that you see. That is really the problem. And sometimes you don't find it until you are in there a while. The fellow who comes in to see you and starts to tell you about a problem may be rationalizing a problem, it may be his own incompetency, it may be he did not see the problem coming. He may have tried to corner the market or have the largest selection of something available and not realize that he is paying the interest charges on the cost of maintaining that inventory; it may be improper management.

Mr. CITRON. I think your question, Mr. Williams, went a little beyond that. Not just what happens to the individuals who we represent. I think it goes back to what Mr. Luken had indicated earlier.

Mr. Pierson does not believe in a huge debt by the Government. I thought I deduced that from what he said, that he would like a balanced budget. I don't believe in a balanced budget. The Government is not a business. A business looks to make a profit, but I would like to see some of those expenses diminished. Whether it can be done by means of reducing taxes and spending more, I am

not prepared to say, and I know you don't want to discuss politics today.

I choose to think that if we cut down on spending and perhaps let the taxes stay where they were, or go up just a little bit, because the pump does not seem to have been primed as a result of the cut in taxes—I don't like to pay any more than I have to any more than anybody else, but I am ready to pay it. I think most people are ready to pay it.

My business will continue whether we have another case or we don't have another case.

I was president of the Bankruptcy Lawyers Bar Association for a couple of years. We have seminars. I am on the New York State Bar Association Bankruptcy Committee, the New York County Lawyers Bankruptcy Committee. We all try, and I don't know the solution other than to try to cut down on spending and perhaps increase the tax.

Mr. WILLIAMS. I just have one more question, Mr. Chairman. There is one thing that is bothering me. I have been in Congress for 4 years. I do not pretend to know everything. Let me begin by saying that.

One thing I have struggled with as a Member of the Congress is whether or not Government can effectively deal with what is happening in the small business community, for example, which is why we are here today, or in my area, what happens to the steel industry.

There is a struggle going on, and my colleague knows about it better than I. Many people believe we have a great deal to say about where this country is going in the business community and the industrial community. From what I am hearing from you, I am not sure we do. And that is why I guess we are here, and we do this all over the country, trying to get some input.

But if we did everything right in Washington, everything, if that was possible and it is not, would it change?

Mr. CITRON. It might very well.

Mr. WILLIAMS. Excuse me. Just to further extend my thought, we have gone through a couple of decades where government has assisted small business. We continue to do that, although not as we have in the past. Was that really the answer? Or is what we are doing the answer? I am struggling with that as a member.

Mr. CITRON. Well, I don't want to bite the hand that feeds me. Representing a small business SBIC, I am not so sure that is the solution, because it is not that easy to borrow from them.

Mr. WILLIAMS. Each program has its ups and downs.

Mr. CITRON. I appreciate that. I personally would have no opposition to more Government lending to small business. I don't mind if you bail out Chrysler. I don't mind if you bailed out the Youngstown steel mill. I think that is one of the purposes of Government. I would not mind if that was done. That is maybe what we require.

We represent companies that have EDA loans, which has only the backing of the same assets of the company and not of the State through which it is issued, and these bonds are picked up because there is less interest, less taxes paid, no taxes may be paid, the banks come through—so that you can get an EDA loan at 70 per-

cent of prime, 72 percent of prime. These people gobble it up, and they use that money; they need it.

Now, obviously if everybody went through with an EDA loan, there would be no tax paid to the Government. So it might be defeating itself. But you would be keeping somebody in business at the same time.

Mr. WILLIAMS. Well, Mr. Stockman claims that is what is driving up interest rates as much as the deficit, Government lending programs and loan guarantee programs. I am not holding to that theory.

Mr. PLATZER. I question the ability of the Government to supervise or control such a loan, sir. Now you are turning Government into a banking business.

Mr. WILLIAMS. I guess the bottom line is to continue to do that?

Mr. CITRON. I would. I would continue to do it. I would continue to lend every governmental assistance wherever it is required. A bank is not in a position to do that. It is beholden to its depositors and stockholders.

You might say the Government is beholden to its citizens. But we are all in that pocket. The bank is an individual entrepreneur; it is in business to make money. I don't feel sorry for the widows and orphans, as Mr. Dooley used to say, with their stocks and bonds. But by the same token, if there were an input so that you could get the funds easier, not through an SBIC—it can be done—and let these fellows have a lower expense in the interest that they are paying, a longer time to pay it out, I think that that might help considerably.

Mr. WILLIAMS. Thank you.

Mr. LUKEN. Thank you, Mr. Williams.

I believe a lawyer's time and advice are his stock in trade. I am saying that just by way of recognizing the substantial and tangible contribution you have made, not only to the contributing material that we wanted to hear, and your wise counsel, but also your sacrifice in spending the time with us. We appreciate it.

If you can stay, we would like you to. If you cannot, that of course will be your decision.

Mr. CITRON. It is the least we could do.

Mr. LUKEN. Thank you.

And now, Mr. Schochat.

You are vice president for Urban Services of the Chemical Bank of New York. We thank you for coming early and sitting through the hearing up to now.

I think staff has wisely arranged matters here from the witnesses, because we had the background and the problems from the individuals who might be considered the victims of the problem that we have, that we are dealing with and then the attorneys who have handled these matters.

Now we will be talking to a member of the banking community, Mr. Schochat.

You have given us your prepared statement dated June 25, 1982. If there is no objection, that will be entered into the record of the committee. You may now proceed to tell us whatever you think we need to hear on this subject.

TESTIMONY OF MICHAEL SCHOCHAT, VICE PRESIDENT, URBAN SERVICES, CHEMICAL BANK, NEW YORK CITY, N.Y., ACCOMPANIED BY GLORIA M. OBSTFELD, ASSISTANT VICE PRESIDENT FOR URBAN SERVICES

Mr. SCHOCHAT. Thank you very much, Mr. Chairman.

Mr. LUKEN. You do not have to follow the statement, but that will be your discretion.

Mr. SCHOCHAT. Thank you.

Mr. Williams, Mr. Chairman, and other members, and the witnesses who are here—this morning I found quite a bit of information and certainly the testimony from my perspective is very beneficial. Certainly in my capacity at Chemical Bank we work very much with the grassroots type of businesses here in New York City.

As director of urban services of the bank, we try to use our banking facilities and our capital to help small businesses in New York City, developing the necessary partnerships with governmental programs, especially SBA, city programs, State programs, and also programs with the Federal Government—not only in small businesses, but also in another market, which is the housing construction business—hopefully rehabilitating a lot of the housing stock of New York City which, as you know, has been quite depressed, especially in the impact areas of the Bronx, Brooklyn, et cetera.

What I will try to do this morning is just gleen over my statement—the statement is not long—and be very receptive to any questions, not only from the witnesses, but certainly from the subcommittee members.

Again, on behalf of Chemical Bank, I would like to express my appreciation for the opportunity to appear here and to discuss not only the bank's commitment to the development of small businesses in New York, but hopefully shed some light from my perspective as to the scenario—economic, business, et cetera—that is impacting on small businesses.

Chemical Bank's commitment to small business is founded in the belief that the vital health of the local economy is closely tied to the growth of the small business community. Therefore, it is clearly in the interest of our retail banking customers and ourselves to help promote greater business activity. We believe that providing credit and services to small business is a vital function at Chemical and helps stimulate a growing economy.

While most big banks have tended to focus their resources in the retail banking customers and larger business entities, the small business market has largely been ignored.

Our market research indicates that Chemical supplies credit to more small businesses in New York than any other bank. We have a table attached to my testimony to indicate that. Just to give you a percentage of the market that we service, we have 25 percent of the share of credit relationships in the small business market versus the competition of 21, 16, and 10 respectively, which is Manufacturers Hanover, Citibank, and Chase. This is a source from Lou Harris and Associates.

What we define as small business are firms with annual sales of less than $5 million. This is where I put my whole thrust today. I

have testimony about much larger businesses and larger commitments and larger loan demands that specific businesses need.

Most of the businesses are in the retail and service sectors, with nearly equal number in manufacturing, wholesaling, and finance. I give you the distribution in table 2.

With our network of 250 branches in the New York area, we have in place the delivery system to effectively service the total needs of the small business community. Despite our size, we are very much a community-oriented bank. Our branch managers function as if they were the presidents of single unit banks which their branches represent, since this is the way that consumers and business view them.

They are capable of making independent credit decisions and providing assistance in the most direct manner. The lending process is essentially the same for small business as for larger business. I think this gets into the crux of some of the issues we discussed, namely, the process issue.

The risks are somewhat higher due to a variety of factors such as the relative value of a firm's assets, and the quality of independent financial information, which is really our source of making a decision for credit. Therefore, in order to lend to these businesses, a banker must have a close working relationship with the small business. Lending in this segment is often very intuitive, because the perceived entrepreneurial qualities, that is to say, the character of the business, are relatively more important than in larger corporate lending.

Let me go a little afield to state that in my experience, from what I have seen, one of the key determinants in having a business become successful, and having a banker become receptive to their particular needs, is really an educational process, that is—I am talking about a small businessman, or a startup operation—how does that businessman approach a banker, how does the businessman make the banker a partner in his or her particular venture.

I find specifically in the small startup operations and specifically in the minority businesses that this is a threshold that is very, very difficult to overcome.

For those of you who have testified today, you have been in business 15, 20, 25 years, you know these relationships. But the high failure of new startup operations, which are certainly documented by Dun & Bradstreet, and others, seems to indicate to me that this technical assistance, this educational process, is very necessary for the small businessman. And we have, from a public relations standpoint, and from a marketing standpoint, tried to do that.

I have left some kits with you, to indicate what technical assistance we offer that small businessman to hopefully diminish that failure rate, in order to give that individual that experience factor, what tools they need, what sources of funding they can go to, either governmental, banking, or private, and to give them the necessary capital in order for them to achieve their particular goals.

There are several types of problems small businesses have, especially in trying to secure credit. Many small businesses are undercapitalized, and most of the credit needs of small businessmen are for working capital. Our branch managers generally have the authority to approve credits of this nature and size. But we are also

better organized to provide longer term credits to this segment than are many other banks.

My group, the urban services group, works with customers to devise acceptable methods for obtaining financing—specifically through Chemical's conventional and special loan programs. The cornerstone of the group that we are involved with is the use of the bank's funds to leverage other available funding, private and public, to insure the viability of an endeavor and provide the greatest possible benefit per dollar invested.

I think Mr. Citron stated it very well, Mr. Williams, when he indicated should all these funding and Federal programs be eliminated. I have been working with these Federal programs now for over 3 years. I add that to the fact that I have done a stint with the city of New York, as deputy commissioner under the umbrella of Chemical Bank. Chemical Bank has actively participated with all these various programs which the urban services group forms a partnership with those particular programs.

It ranks with the New York City Economic Capital Corporations' revolving loan fund, where they do project financing, as well as with other agencies, such as the New York State Urban Development Corp., Job Development Authority, New York City Public Development Corp., et cetera.

We call those programs alphabet soup, but they are there really to leverage, and to form a balance between the interest rates that we charge and the discounted rates that those programs charge to the businessmen.

We also work with minority enterprise small business companies, such as Mass Minority Equal Credit Corp. and Ban Cap Corp.

Now, it is very, very important for the small businessman to know these sources. And if they do not know these sources, they would go to conventional lenders, and then would have the additional expense of paying that particular higher rate, which is usually prime plus 2, or 2.5, as far as the small businessman is concerned.

We also continue to actively pursue loans for local business development through the SBA guaranty program. Just to give you a little bit of background, for the most recent SBA fiscal year, September 30, 1981, we originated over $7.5 million in loans, becoming the second most active bank participating in the New York SBA region. Our total portfolio in SBA guaranteed loans was over $22 million as of December 31, 1981. We continue to be the leading minority-owned SBA lender.

Mr. LUKEN. You did not give us any figures on that. Do you have figures on loans to minority-owned businesses?

Mr. SCHOCHAT. I do not have the specific figures available, but I can supply them to you.

Mr. LUKEN. I did not mean an exact figure. Do you have a general idea?

Mr. SCHOCHAT. We have approximately 196 SBA loans in our portfolio. I would not want to guess.

Mr. LUKEN. OK.

Mr. SCHOCHAT. While the mandate of the U.S. Small Business Administration is to provide credit accommodations to small businesses that cannot otherwise obtain needed capital on reasonable

terms, it is clear that SBA lending policies have become much more stringent in recent months. The tightening of credit policy is due to the heavier than usual SBA obligation to repurchase delinquent loans from banks.

Also contributing to the more stringent policy is the poor business economy, especially for startups and for existing small business. Recent SBA guidelines to banks mention that while their program may offer repayment terms and collateral requirements more liberal than would be the case under normal bank policies, SBA general credit requirements are now similar to those of the banks.

Recent meetings with SBA finance personnel indicate that they are looking more closely at the equity capitalization put in by the principals, as well as the overall viability of the loan proposal. The loan request must be of sound value and must demonstrate that past earnings records and future prospects of the firm indicate ability to repay the loan and other fixed debt, if any, out of cash flow.

SBA is now taking any available collateral to secure the loan, and this is especially true of real estate. Second mortgages on residences owned personally by the principals are more frequently being taken to secure their business loan. On startups, SBA is requesting 50 percent hard collateral—machinery, equipment, real estate—plus 25 to 50 percent equity. In some instances, it is more stringent than we require.

For existing businesses, the ratio of debt/worth—including the proposed loan—should not exceed 3:1. Viability of the overall business plan and reasonable assurance of repayment ability are crucial requirements.

There exist several weaknesses inherent in the nature of small businesses, which are even more critical in a high interest rate economy. The failure rate is most severe among young, or startup, small business operators without adequate experience and technical knowledge needed to weather decreases in sales and higher costs of borrowing and expenses.

Also seriously affected are owners of older companies who, at these periods, are more likely to choose retirement over costly expansion or relocation. It was mentioned here, recent values in New York City specifically have skyrocketed tenfold to twentyfold. We are even experiencing this in our branch system where long-term leases have run out and when we are now renewing those leases, we are faced with lease renewals of 5 to 10 times as much as we paid previously.

And this, of course, impacts on our bottom line as to the operation of that specific branch.

Mr. WILLIAMS. Could I interrupt you right there?

Let's say that the particular company you are talking about did not pick up the lease. Do you have any track record as to what has happened to the facility they were leasing? Would they rather try to charge 5 or 10 times the rent, or leave it vacant?

Mr. SCHOCHAT. That is a hard correlation to kind of measure, based on the fact that——

Mr. WILLIAMS. Do they have someone ready to take it?

Mr. SCHOCHAT. Yes. The competition is there, especially in New York City. Space is at such a premium, and it is such a market where the real estate agent has really all the marbles.

Mr. WILLIAMS. This is unique, I think, here, because in Youngstown, for example, they cannot get somebody to fill the empty storefronts.

Mr. SCHOCHAT. I was talking about prime property. This is where you get the overflow occurring in areas such as Long Island City, Queens.

Mr. WILLIAMS. That is the other result, they are moving out into other areas.

Mr. SCHOCHAT. Yes. You get the gentrification concept occurring in the outer boroughs, once Manhattan is saturated.

The majority of small businesses are handicapped in their ability to borrow, due to their level of undercapitalization, as stated above, as well as inexperience in preparing financial statements and in presenting past track records and business plans for long-range growth.

Dun & Bradstreet lists the main causes of business failure to be the lack of experience, inadequate sales, and competitive weakness. Also cited as contributing factors are: Heavy operating expenses; receivable difficulties; inventory difficulties; excessive fixed assets; and business depression.

It is estimated that 10 to 15 percent of these companies turn to suppliers or relatives for short-term funding, placing themselves and their sources in precarious financial positions during times of high demand/cost of money. Last, it is felt that the leniency of the personal bankruptcy laws serve sometimes to encourge greater risk-taking in some small business ventures.

Ultimately, extreme weakness in the financial health of corporations shows up in the statistics of business failures, as published by Dun & Bradstreet. Business failures in 1981 totaled 17,043 firms, a little below the postdepression record reached in 1961. Judging from the number of failures in the first 4 months of this year, it appears that 1982 will easily set a record for the highest number, as well as the highest rate, of failures since the early 1930's.

While the liberalization of the bankruptcy laws in 1979 may account for some of the increase in recent bankruptcies, the current situation is certainly worrisome. Fortunately, today's bankruptcy rate is not nearly as bad as during the Great Depression. For example, the failure rate per 10,000 listed corporations was an estimated 82, annual rate, in the first 4 months of this year, versus 154 in full year 1932 and 100 in full year 1933.

It is almost like looking at the glass: Is it half empty or half full?

It is the feeling of the entire business community that high interest rates are a major roadblock to growth. Often the blame falls on the bank by the public. Unfortunately, these rates continue to reflect that inflation remains too high and that there continues to be a fear of diminished support for the Federal Reserve Board's anti-inflation policy.

Although inflation showed a dramatic drop during the first quarter of this year, the consumer price index increased 1 percent in May, equivalent to an annual inflation rate of 12 to 13 percent. For interest rates to drop significantly, an annual inflation rate of under 6 to 7 percent is necessary. Inflation increases the demand for credit and erodes the investors value of money. The demand for

credit and the need for Government borrowing must be significantly reduced if rates are to drop.

Mr. LUKEN. Could I interrupt right there? I am not sure how far you are going in these comments right here, or what points you are making. But if we could, let's stop and discuss one or two of the matters that you bring up.

I guess I would infer that you are not at all confident that the deflation of the first quarter is going to continue, right?

Mr. SCHOCHAT. I agree.

Mr. LUKEN. What I would observe is even during that period of the first quarter before the May increase, the general observations almost everyone seemed to be making—you can challenge that if you think it should be—is even though deflation or disinflation, whatever it is called, is occurring and might continue to occur, interest rates were expected to keep up and to come down slightly, if at all. Isn't that correct?

Mr. SCHOCHAT. Yes.

Mr. LUKEN. Then the inflation would not seem to be the undergirding for the high interest rates, or the basis of the high interest rates based on that set of facts.

Mr. SCHOCHAT. I see your rationalization, Congressman. My personal opinion is that other factors need to be considered. And I think the time factor is a very, very important part in this whole equation.

We are trying to turn around an economic situation that has grown to this particular "crisis," and that is what you hear—that has grown into this crisis that took place for the last maybe 10 to 15 years.

And to project certain things occurring very, very quickly that the administration, that yourself, that a lot of the economic improvements have taken place, that too plays only in a 6- to 9- to 12-month period, is very, very difficult to say, to get that type of effect. That if inflation does go down within a quarter or even a half year, the impact or the ripples to decrease interest cannot occur in tandem with that.

If you take a look at last year, interest rates were at a 20- to 22-percent rate. This year it is at the 16½-percent rate. You have almost a 25- to 30-percent reduction in interest rates. What is worrisome to the business community is the continuous level that it does continue at, which is still a very, very expensive piece in this particular balance sheet.

[Mr. Schochat's prepared statement with attachments follows:]

PREPARED STATEMENT OF MICHAEL SCHOCHAT, VICE PRESIDENT, URBAN SERVICES GROUP, CHEMICAL BANK, NEW YORK CITY, N.Y.

Mr. Chairman, members of the committee, on behalf of Chemical Bank, I would like to express our appreciation for the opportunity to appear before this committee to discuss Chemical Bank's commitment to the development of small business in New York.

Chemical Bank's commitment to small business is founded in the belief that the vital health of the local economy is closely tied to the growth of the small business community. Therefore, it is clearly in the interest of our retail banking customers and ourselves to help promote greater business activity. We believe that providing credit and services to small business is a vital function at Chemical and helps stimulate a growing economy. While most big banks have tended to focus their resources

on the retail banking customer and larger business entities, the small business market has largely been ignored.

Our market research indicates that Chemical supplies credit to more small businesses in New York than any other bank (see Table I). What we define as small business are firms with annual sales of less than $5 million. Most of the businesses are in the retail and service sectors with nearly an equal number in manufacturing, wholesaling, and finance (see Table II).

With our network of 250 branches in the New York area, we have in place the delivery system to effectively service the total needs of the small business community. Despite our size we are very much a community-oriented bank. Our branch managers function as if they were the presidents of single unit banks which their branches represent—since this is the way that consumers and business view them. They are capable of making independent credit decisions and providing assistance in the most direct manner. The lending process is essentially the same for small business as for larger business. The risks are somewhat higher due to a variety of factors such as the relative value of a firm's assets, and the quality of independent financial information. Therefore, in order to lend to these businesses, a banker must have a close working relationship with the small business. Lending in this segment is very often intuitive, because the perceived entrepreneurial qualities, that is to say, the character of the business, are relatively more important than in larger corporate lending.

There are several types of problems small businesses have, especially in trying to secure credit. Many small businesses are undercapitalized, and most of the credit needs of small businessmen are for working capital. Our branch managers generally have the authority to approve credits of this nature and size. But, we are also better organized to provide longer term credits to this segment than are many other banks. Getting a term loan which can function as new equity capital is an area where small businesses generally encounter difficulties.

In addition to Chemical's branch services, the urban services group of Chemical Bank, which I direct, works with customers to devise acceptable methods for obtaining financing, specifically through Chemical's conventional and special loan programs. The cornerstone of the urban services group is the use of the bank's funds to leverage other available funding, private and public, to ensure the viability of an endeavor and provide the greatest possible benefit per dollar invested. Chemical has actively participated with the NYC Economic Capital Corporation's Revolving Loan Fund in project financing, as well as with other agencies: the NYS Urban Development Corporation, Job Development Authority, and the New York City Public Development Corporation. The Urban Services Group works with minority enterprise small business companies such as Minority Equal Capital Company, Inc. and Ban Cap, Corp.

Chemical continues to actively pursue loans for local business development through the Small Business Administration guarantee programs. For the most recent SBA fiscal year ending September 30, 1981, Chemical Bank originated $7,639,499 in loans, becoming the second most active bank participant in the N.Y. SBA region. Chemical's total portfolio for SBA guaranteed loans were $22,500,000 as of December 31, 1981. Chemical continues to be the number one lender of SBA loans to minority-owned businesses.

While the mandate of the U.S. Small Business Administration is to provide credit accommodations to small businesses that cannot otherwise obtain needed capital on reasonable terms, it is clear that SBA lending policies have become much more stringent in recent months. The tightening of credit policy is due to the heavier than usual SBA obligation to repurchase delinquent loans from banks. Also contributing to the more stringent policy is the poor business economy, especially for startups and for existing small business. Recent SBA guidelines to banks mention that while their program may offer repayment terms and collateral requirements more liberal than would be the case under normal bank policies, SBA general credit requirements are now similar to those of the banks.

Recent meetings with SBA finance personnel indicate that they are looking more closely at the equity capitalization put in by the principals as well as the overall viability of the loan proposal. The loan request must be of sound value and must demonstrate that past earnings records and future prospects of the firm indicate ability to repay the loan and other fixed debts, if any, out of cash flow. SBA is now taking any available collateral to secure the loan and this is especially true of real estate. Second mortgages on residences owned personally by the principals are more frequently being taken to secure their business loan. On startups, SBA is requesting 50 percent hard collateral (machinery, equipment, real estate) plus 25 percent to 50 percent equity. For existing businesses, the ratio of debt/worth (including the pro-

posed loan) should not exceed 3:1. Viability of the overall business plan and reasonable assurance of repayment ability are crucial requirements.

There exist several weaknesses inherent in the nature of small businesses which are even more critical in a high interest rate economy. The failure rate is most severe among young, startup small business operators without adequate experience and technical knowledge needed to weather decreases in sales and higher costs of borrowing and expenses. Also seriously effected are owners of older companies who, at these periods, are more likely to choose retirement over costly expansion or relocation. The majority of small businesses are handicapped in their ability to borrow, due to their level of undercapitalization, as stated above, as well as inexperience in preparing financial statements and in presenting past track records and business plans for long range growth.

Dun & Bradstreet lists the main causes of business failure to be the lack of experience, inadequate sales, and competitive weakness. Also cited as contributing factors are: heavy operating expenses, receivable difficulties, inventory difficulties, excessive fixed assets, and business depression. It is estimated that 10 to 15 percent of these companies turn to suppliers or relatives for short term funding, placing themselves and their sources in precarious financial positions during times of high demand/cost of money. Lastly, it is felt that the leniency of the personal bankruptcy laws serve sometimes to encourage greater risktaking in some small business ventures.

Ultimately, extreme weakness in the financial health of corporations shows up in the statistics of business failures (as published by Dun & Bradstreet). Business failures in 1981 totaled 17,034 firms, a little below the post-Depression record reached in 1961. Judging from the number of failures in the first four months of this year, it appears that 1982 will easily set a record for the highest number, as well as the highest rate, of failures since the early 1930's. While the liberalization of the bankruptcy laws in 1979 may account for some of the increase in recent bankruptcies, the current situation is certainly worrisome. Fortunately, today's bankruptcy rate is not nearly as bad as during the great Depression. For example, the failure rate per 10,000 listed corporations was an estimated 82 (annual rate) in the first four months of this year, versus 154 in full year 1932 and 100 in full year of 1933.

It is the feeling of the entire business community that high interest rates are a major roadblock to growth. Often the blame falls on the bank, as it is assumed by the public that high interest rates are established by the financial institution alone. Unfortunately, these rates continue to reflect that inflation remains too high and that there continues to be a fear of diminished support for the Federal Reserve Board's anti-inflation policy. Although inflation showed a dramatic drop during the first quarter of this year, the consumer price index increased 1 percent in May, equivalent to an annual inflation rate or 12-13 percent. For interest rates to drop significantly, an annual inflation rate of under 6 to 7 percent is necessary. Inflation increases the demand for credit and erodes the investors value of money. The demand for credit and the need for government borrowing must be significantly reduced if rates are to drop.

While recent figures on the rate of business failure may be high, we feel there is still growth potential in the New York market. Specifically, the services sector, which consist mostly of small businesses, appears to have tremendous growth potential (see Table III, IV, V). Therefore, we expect to continue our emphasis on small business lending into the foreseeable future.

Continuing efforts to service the small business community are exemplified in the formation of the "Business Action Unit," a pilot project Chemical has created to specifically meet the needs of small businesses in the Westchester community of Mount Vernon. This unit consists of a specialized group of bankers who provide financial services in everything from payroll administration and investment options, to overseas banking for small business in the area. Chemical is the only bank which guarantees to the small businessman in Mount Vernon that a credit request will receive an initial response within 72 hours. Mount Vernon has a high concentration of small businesses, the largest number per capita in Westchester County.

With the success of this model program, Chemical hopes to implement other such programs in urban areas throughout New York. Chemical's assistance in this area will undoubtedly help to strengthen an area's growing economic base as well as enhance the positive relationship the Bank has established with the small business community.

TABLE I.—*Share of credit relationships*

	Percent
Chemical	25
MHT	21
Citibank	16
Chase	10

Source: Louis Harris & Associates.

TABLE II.—*Small business industry distribution*

Type of firm:	*Percent of market*
Retail	25
Financial/insurance/real estate	14
Wholesale	12
Manufacturing	10
Other services	32
Miscellaneous	6

Source: Dun & Bradstreet.

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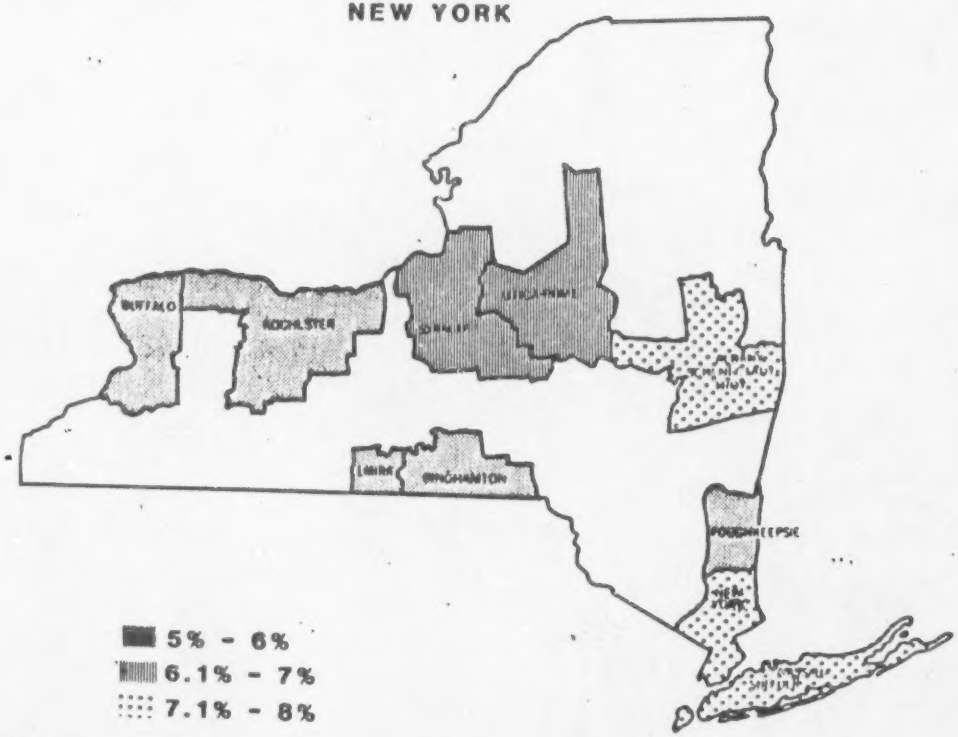
TABLE III

EMPLOYMENT PERCENT CHANGE PROJECTIONS 1978-1990

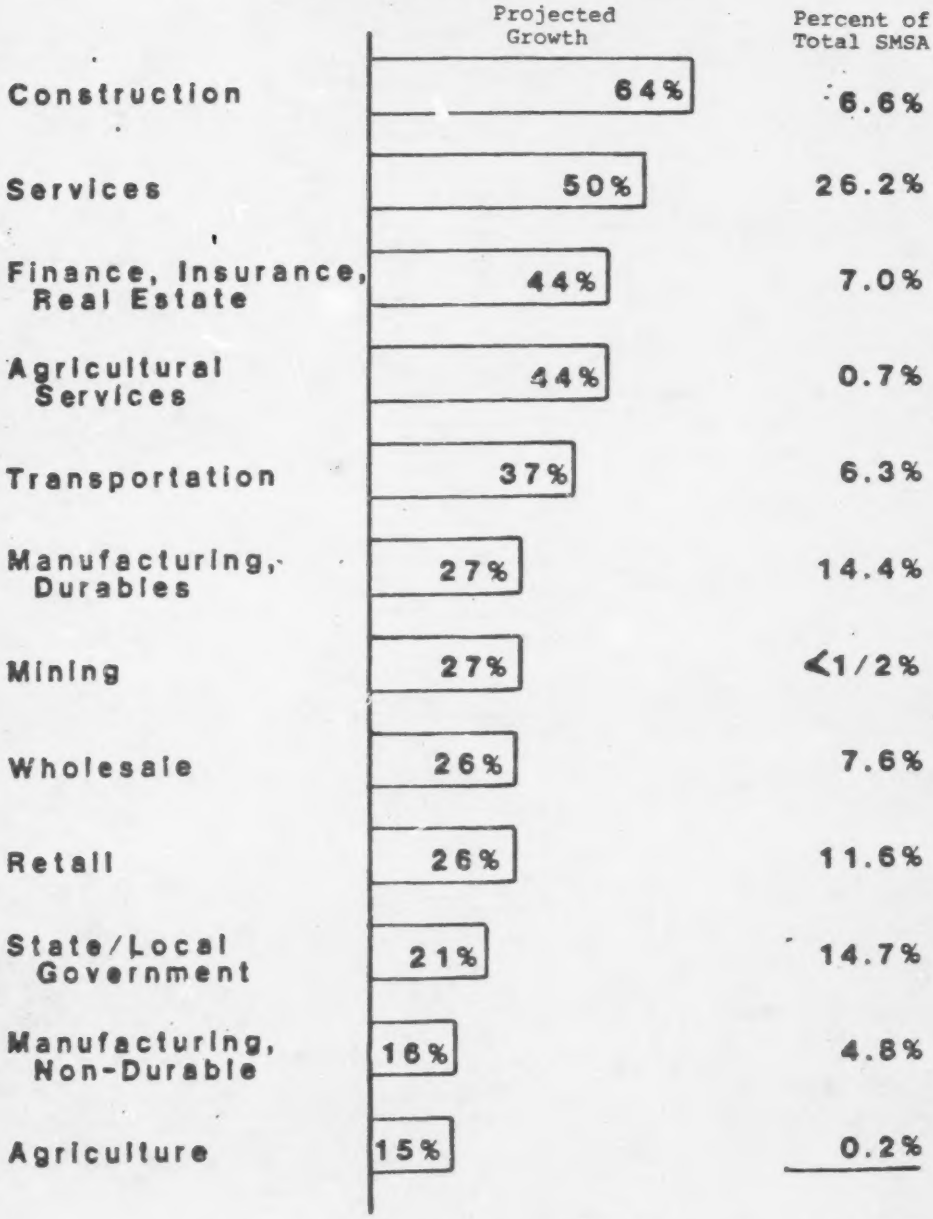
NEW YORK



SOURCE: Bureau of Economic Analysis Regional Projections (1980 OBERS) (July 1981)

1978 - 1990
FORECAST
INCOME CHANGE
NASSAU-SUFFOLK SMSA

TABLE V

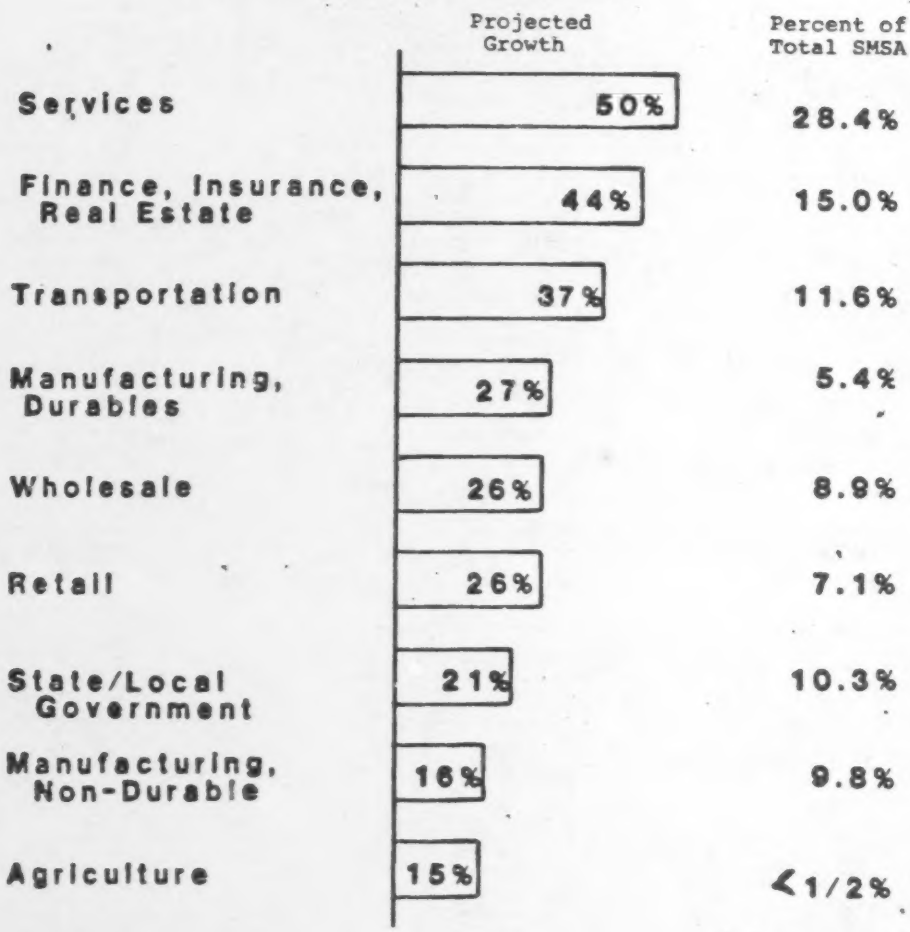


SOURCE: Bureau of Economic Analysis

100.0%

1978 - 1990 FORECAST INCOME CHANGE NY - NJ SMSA (NY Part)

TABLE IV



SOURCE: Bureau of Economic Analysis

How the Banks Are Squeezing Small Business

They charge higher rates on loans and more for their services. Old relationships have faded, and some banks even shun small companies.

By ROBERT A. BENNETT

MANY of the country's small businesses are recounting experiences similar to that of Utility Industries of Somerdale, N.J.

"If we borrow, it's two or three percentage points above the prime rate, while big companies borrow well below the prime," said Wiley J. Pickett, owner of the $600,000-a-year company, which makes devices to pull cables through conduits. "Not that I'm complaining about what big business gets. It's what small business doesn't get," Mr. Pickett added.

Then there's the kind of experience of another small company, Accurate Inventory Services in New York successes. The company, which does inventory accounting for client retailers, had been doing business with the Chase Manhattan Bank for almost 20 years. But then Chase told the company to take its business elsewhere.

"They said they couldn't make enough money on a $25,000 loan," said Arnold S. Gerber, the Accurate inventory's president. "They made no bones about it, they literally told me to go to another bank," Mr. Gerber said.

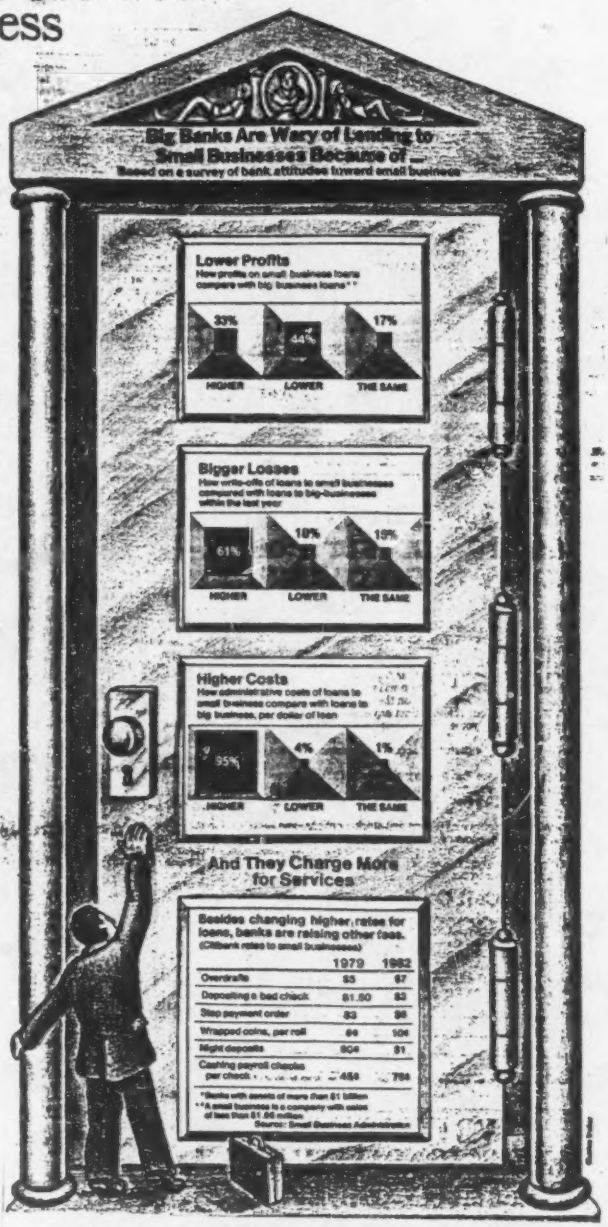
The Government says that of the 11 million businesses in the United States, 10.8 million are categorized as small, with fewer than 500 employees. They are called the backbone of the American economy, with good reason.

According to the Small Business Administration, these companies have generated more than half of the new product and service innovations developed since World War II. In addition, they employ about 56 million people, or half the nation's work force. Most of them rely on the nation's banks to provide them with the finance to grow and the funds to ease them through the shoals of the economy's cycles.

Of late, many of these companies have found those relationships becoming increasingly uncomfortable. The banks have been charging small business higher interest rates than big business. They have been raising the fees they charge for their services far beyond the general rise of prices. And some banks have been turning their backs on their small-business customers of many years.

What's more, many small banks, themselves small businesses, are being gobbled up by bigger banks. As a result, the banks have been shedding the personal relationships that gave a small bank confidence in its bor-

The banks, for their part, say they have little choice. They note that many small banks have been forced to merge into larger banks because their costs were running far ahead of their small-town fees. At the same time, the small banks' own cost of money — what they pay on their deposits — has been soaring to keep deposits from fleeing town to high-yield money market funds and the like. No longer, therefore, can a small bank lend a small business insulated from economic trends beyond their local community.


Big Banks Are Wary of Lending to Small Businesses Because of ...
Based on a survey of bank attitudes toward small business
Lower Profits
How profits on small business loans compare with big business loans**
33%
44%
17%
HIGHER
LOWER
THE SAME
Bigger Losses
How write-offs of loans to small businesses compared with loans to big businesses within the last year
61%
19%
19%
HIGHER
LOWER
THE SAME
Higher Costs
How administrative costs of loans to small business compare with loans to big business, per dollar of loan
95%
4%
1%
HIGHER
LOWER
THE SAME
And They Charge More for Services
Besides charging higher rates for loans, banks are raising other fees.
(Citibank rates to small businesses)
1979 1982
Overdrafts $5 $7
Depositing a bad check $1.50 $3
Stop payment order $3 $6
Wrapped coins, per roll $4 $4
Night deposits $24 $1
Cashing payroll checks per check $.44 $.75
*Banks with assets of more than $1 billion
**A small business is a company with sales of less than $1.56 million
Source: Small Business Administration

NY Times-April 25, 1982

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FOR their part, the banks say that dealing with small business is more time consuming, more costly and riskier than dealing with a General Electric or I.B.M. Banks contend they must either charge enough to cover their costs to make a profit, or close business with small companies entirely, and different banks have taken different courses. The Bankers Trust Company, for example, has nearly stopped dealing with very small enterprises — mom and pop stores and the like. Others, by contrast, have geared up for this kind of business and are eagerly courting it.

"It's a very profitable marketplace for us," said Robert I. Lipp, senior executive vice president of the Chemical Bank, which has been particularly aggressive in seeking the business of small companies.

Courted or not, the credit situation at many small companies appears to be nearing a critical point — and for some bankrupt businesses, that point already has been reached. The fear, according to Milton D. Stewart, editor of Inc., a magazine for small business and head of the Small Business Administration under President Carter, is that the number of small-company bankruptcies will continue to soar as a result of the recession and high interest rates. Now businesses

Continued on Page 34

Continued from Page 1

have been forming at a healthy rate in recent years — but they have been collapsing at record rates as well.

According to the Small Business Administration, only about one out of every three new companies with fewer than 20 workers survive more than four years, and fewer than one out of 10 survive a decade.

"Small business needs credit in place of equity," Mr. Stewart said. "How far can you stretch the rubber band?"

High interest rates are a major problem, but a greater problem is the mere availability of credit, Mr. Stewart continued. And this problem is getting worse as small banks, which account for two-thirds of all credit to small business, are being swallowed by bigger banks.

To the average small-business man, the situation is confusing as well as difficult. He sees one bank raising rates and wooing him, and another pushing him out the door.

Jackie Kleiner, for example, an attorney in Atlanta who is suing several banks on behalf of small businesses, claims that by raising their fees

"banks are showing they don't want these customers." But Mr. Kleiner also accuses the banks of charging small concerns so much that "the small-business community is subsidizing the big-business community."

Interviews with small companies around the United States turned up numerous complaints, but banks, citing the confidentiality of their relationships, usually would not discuss their relations with specific customers.

MANY of the businessmen interviewed said that money isn't everything, even when it comes to banking. Often, a businessman's relationship with his bank takes on a personal tone, making the small-business man reluctant to switch accounts.

Paul Seerveus, chairman of the Seerveus Company, a food-equipment distribution and refrigeration business in Haledon, N.J., recalled how his relationship changed after his local bank was taken over by a bigger bank — which he won't name, he said, because "I owe them money."

"It's not like it used to be," Mr. Seerveus said. "We've just become a number," he said. "It's very impersonal. The people who make the decisions are 20 miles away."

The Seerveus Company has sales of between $4 million and $5 million a year, and usually has about $30,000 in credit outstanding, paying a rate of one to one and a half percentage points above prime. "It has been worse in the past," he said.

In dealing with big banks, small-business men complain of a lack of understanding. William H. Kelly, president of Bank and Office Interiors Inc. of Seattle, contends that the failure of the Seattle-First National Bank to comprehend his business was the reason his company switched its business to the First Interstate Bank of Washington.

Citing a study by the Stanford Research Institute, Mr. Kelly contended that his industry was rapidly expanding and changing. "We no larger can be a mom-and-pop type operation," he said. His company now has annual sales of about $20 million, and has been growing at a yearly rate of 15 to 20 percent, Mr. Kelly said.

At the same time, Mr. Kelly added, the basic character of his business is changing. The price of the employee work stations that he sells has soared to about $3,500 per unit, from only $900 to $700 five years ago. "That means we need more credit," he said.

SEATTLE-FIRST NATIONAL was unwilling to finance "what was mainly our in-process inventory," Mr. Kelly continued. Thus, he moved the company's account. Now, Mr. Kelly added, his credit needs are met — at one and a half percentage points above prime.

Mr. Pickett of Utility Industries. like many other small-business men, contends that "banks will only lend when you don't need it."

One of Mr. Pickett's biggest complaints is the difficulty he has in getting short-term loans so that he can get large discounts on materials by paying early. Too often, he said, his bank will not go along.

Mr. Pickett said he might consider going to an accounts-receivable or factoring company, which would lend against the security of either the goods produced or the purchasers' promises to pay. But he said such companies charge interest rates and fees that are so high they wipe out any potential benefits. Even with their high rates, banks still offer the lowest rates available to small business.

Meanwhile, bankers contend that it often takes a lot more time and effort to determine the creditworthiness of a small business than of a major corporation, and that often a lot more paperwork is involved, especially if the loan is guaranteed by the Small Business Administration.

In addition, the income earned on a small-business loan, even at a high rate, is tiny compared with that earned on a big loan. For example, if the prime rate is 10½ percent, and a bank makes a $20 million loan to a major company at two percentage points below the prime, the bank's annual gross annual income from that loan would be $7.25 million. But the gross income from a $100,000 loan at three percentage points above the prime would be only $19,500. Assuming that the cost of funds to the banks was 2½ percentage points below the prime, the net pretax yield to the bank on the big loan would have been $900,000, and on the small loan, $6,500. Yet, it might have taken more time and substantially more risk to make the $100,000 loan than it did to make the $20 million loan.

At the same time, banks are finding that the cost of services as well as loans have been rising, and, contend they have not been charging enough for rendering services. Thus, there have been sharp increases in many fees.

Citibank is typical. Over the last three years, it has doubled many of the fees it charges the smallest of its business borrowers. If a company deposits a check in its Citibank account and the check bounces, Citibank charges the company $3, up from $1.50 three years ago. Similarly, it has doubled the charge for a stop-payment order, to $6 from $3; it has doubled the fee for each night deposit, to $1 from 50 cents; it has increased the penalty for overdrawn accounts to $7 from $5, and it has raised the price for each roll of wrapped coins to 10 cents, from 6 cents — a high price for retailers, for example, that do a heavy cash business.

But a company may not have to pay any such fees if it can maintain a high enough balance in its checking account. At Citibank, as long as a business keeps at least $1,000 on deposit, it gets a 15-cent credit for each $100, up from 10 cents in 1979. Thus, if the company's balance is large enough, it would not have to pay any direct fees for the services it uses.

The deposits are useful to banks because they are interest-free, and banks can make substantial profits by reinvesting them.

Without such balances, small companies, the banks contend, are expensive to service and the cost of servicing them has to be met either with interest-free balances or direct fees.

It appears that a major problem in the relationships between small-business men and their bankers is that these entrepreneurs do not fit easily into the corporate modes established by the banks. Banks like to set up neat categories so that they can more produce financial services.

The banks expect them to maintain records similar to those of major corporations — a practice that most small-business men say they cannot do. What they want are personal relationships in which the banker understands the basics of the business.

SOME banks in trying to build their small-business divisions, seem to be doing just the opposite of what the small-business men say they need.

Carl Gustavson, senior vice president in charge of Chase Manhattan's community bank division, said that last year the bank set up a special unit to deal with loan applications from small businesses. The applications are gathered at branches and sent to the special unit for approval.

"We recognize that small companies don't have the same kind of financial statements that big corporations do and that's why we set up the special unit, to concentrate our expertise," Mr. Gustavson said. But by moving the loan-application-approval process beyond the branches, it also separates the function from the businessmen. Those banks that have efficiently geared up their small-business activities are enthusiastic about the field because, done properly, it can be more lucrative than lending to bigger companies with more bargaining power.

More than most banks, Chemical seems to have adjusted to the needs of small businesses.

"It all depends on personal relationships at the branch level," said Mr. Lipp. "It's a very personal sell."

Unlike most other large banks, Chemical's branch managers have the authority to make loans of up to $100,000 and they are paid bonuses for generating such business.

According to Mr. Lipp, this policy has more than doubled its small-business checking account deposits over the last five years, to $1.2 billion, from $600 million. If Chemical invested that extra $600 million of interest-free deposits at prime, now 16½ percent, it would increase the bank's pretax earnings by more than $100 million — significant even for a $[illegible] institution. ■

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Mr. LUKEN. I am going to exercise the prerogative of the Chair here, if you don't have any objection. I know I interrupted you and asked you a question. But we are now in an area where we are discussing some of these broad economic questions, and we have an economist here, Mr. Dalio.

Would you mind letting Mr. Dalio make his presentation? He will be the concluding witness. Then we can wind it up in whatever kind of general discussion we want.

I don't mean to abbreviate your testimony. You give us what you plan to give us.

Mr. WILLIAMS. Could I just ask a question now? Why did the Fed drop interest rates in that fall period, if what you are saying is accurate?

Mr. SCHOCHAT. Why did the Fed drop interest rates?

Mr. WILLIAMS. In 1980.

TESTIMONY OF RAYMOND T. DALIO, PRESIDENT, BRIDGEWATER ASSOCIATES, INC., WILTON, CONN.

Mr. DALIO. The demand for money dropped interest. Let me explain, if I can, a little bit. It is assumed—did the money supply go up or down during that period of time? The money supply weakened. You are talking about the 1980 period.

Mr. WILLIAMS. I am talking about the first quarter also.

Mr. DALIO. OK.

Let us say the 1980 period. The money supply went down during that period of time, right? That is a reflection of the demand for money. Now we are seeing the Federal Reserve stimulate money supply. In other words, what the Federal Reserve can do is control reserves, what we call reserves. They cannot control money supply themselves.

Money supply literally is currency in circulation plus demand deposits, checking accounts.

Mr. WILLIAMS. And that was not a similar situation during the first quarter of this year?

Mr. DALIO. We are talking about three different quarters. If we talk about the first quarter of the year, money supply in January, February, and March, particularly in January, exploded.

Mr. WILLIAMS. 1982.

Mr. DALIO. January 1982. We are now talking about that period. What happened—what that resulted in was not an easing of Federal Reserve policy. It was an explosion in the demand for money.

Now, I want to distinguish between money supply and reserves, because the Federal Reserve can control reserves. Indirectly, they can control money supply through the reserves. In other words, a bank has a certain level of reserves. Given that level of reserves, they can loan a certain amount of money out.

What happened was in January there was an explosion of loan demand which caused the money supply to jump. Basically, money supply responds primarily to increases in loan demand. As that loan demand jumped, the Federal Reserve held a very tight control over the money supply, as measured by reserves. You can see that we ran into a shortage of reserves in January and then into early

February. The Federal funds rate skyrocketed during that period of time, and interest rates accelerated during that period of time, because the Federal Reserve was trying to keep a tight control of money supply or reserves in order to restrict money supply growth.

In other words, it is important to understand that the Federal Reserve does not control all the movements of money supply.

Mr. WILLIAMS. That was completely different than that other period of time we talked about during the election.

Mr. DALIO. Absolutely, because then there was a fall in the demand for money, and the money supply fell.

Now, the point I am trying to make is a distinction between reserves and money supply. Prior to the Federal Reserve's existence in 1914, we had volatile swings in money supply. The Fed does not create the money supply. They create reserves.

Now, what happened in the first quarter, the January period, was because of an explosion in the demand and the Fed trying to restrain money supply. They certainly raised interest rates sharply during that period of time. Fed funds jumped sharply. We almost reached having a liquidity panic. You may recall in February, that is when EEC Belgian Prime Minister Martins came over. In mid-February there was a near panic over the question of whether the Federal Reserve in order to enforce their money supply targets would instead drain reserves further, which would force interest rates higher and cause probably a liquidity crisis.

The Federal Reserve at that point in time chose not to do that for fear of the liquidity crisis. Then we got into a whole series of other problems. But in terms of the January period, that was the problem: A surge in the demand for money causing the money supply to grow, and the Federal Reserve trying to restrain it.

Mr. WILLIAMS. Go back to the point the gentleman made in his statement. If inflation is under 6 or 7 percent, interest rates will surely drop.

Mr. DALIO. No. The cost of money is affected by the supply and the demand for money. If you restrict the supply of money, the only way you are going to get the cost of money down is if you kill the demand for money, and in this economy that is a depression.

You can take the relationship between interest rates and inflation rates going back 100 years. Take the Treasury bill rate minus the inflation rate. You will see that went from 13 percent under the inflation rate to 6 percent over the inflation rate over the past 100 years, like a yo-yo. There is virtually no association between interest rates and inflation over the longer term. There has in the post-World War II period been some association between interest rates and inflation, not because of a money supply side, but normally in a recession the demand for money falls along with the demand for goods and services. So, as the demand for money falls, interest rates decline, and as the demand for goods and services fall, inflation falls. That is normal.

What we have instead is a Federal Reserve triggered liquidity crisis. This is not a recession. This is a classic depression. By a depression I don't mean it is just a more severe case of a recession. Most people think if it gets beyond a certain level of severity it is a recession. Instead it is an entirely different degenerative process.

It is a process which is characterized by borrowings increasing while inflation and the demand for money falls. In other words, illiquidity causes companies to increase their borrowings and decrease their inventories in a desperate attempt to improve their cash flow position.

Mr. WILLIAMS. Let's say my colleague and I, and the rest of our colleagues, are successful in getting a balanced budget. Will interest rates come down?

Mr. DALIO. No. The deficit is more the result of the economic weakness than the cause of it. In other words, what happened with the appointment of Paul Volcker in July 1979, monetary policy went from excessively loose to excessively tight. In other words, money supply grew faster than the rate of inflation from 1950 to 1979, and with the appointment of Paul Volcker in July 1979 money supply grew slower than the rate of inflation during that period.

As a result, where interest rates up until then were kept low in relation to inflation, interest rates in 1979, 1980, and 1981 reached the highest level in relation to inflation since 1929. So 1 year in the last 100 years real interest rates were this high, and that is 1929.

Mr. WILLIAMS. I am confused.

Mr. DALIO. As a result of the high interest rates, the economy went down.

Mr. WILLIAMS. I am confused how this all happened in 1 year. I am not a fan of Volcker's, first of all, and his policies, which the record shows. And I am not blaming any administration, that is not my purpose; it doesn't matter to me. Interest rates climbed dramatically from 1976 through 1980.

Mr. DALIO. Real interest rates were low then. Interest rates during that period of time were——

Mr. WILLIAMS. Now you are saying just since the appointment of Volcker in 1979——

Mr. DALIO. We have a shift in monetary policy.

Mr. WILLIAMS. Maybe that is the problem.

Mr. DALIO. It is the problem, yes.

Mr. WILLIAMS. You are telling us nothing we do, the way I am reading what you are saying—if we get inflation to 6 or 7 percent, it is not going to mean anything. If we balance the budget, it doesn't mean anything. The problem is Paul Volcker.

Mr. DALIO. The problem is Paul Volcker's monetary policy. In other words, every time you cut taxes——

Mr. WILLIAMS. You know now much grief we have taken over a balanced budget?

Mr. DALIO. Yes, I know. The argument that the deficit is causing the high interest rates is more the rationalization of the failure of lowering inflation to reduce interest rates.

Mr. WILLIAMS. You said that didn't matter anyway.

Mr. DALIO. What I said was there were those who believed that lowering inflation would lower interest rates. I don't believe that. As a result of that not happening, and the deficit increasing, those same people turn to the deficit and to blame the deficit as the reason that interest rates didn't fall.

Mr. LUKEN. Those same unnamed people.

Mr. DALIO. Most economists a year ago forecasted we would never have a recession. Most economists are misunderstanding what is taking place, in my opinion, because——

Mr. LUKEN. Are you admitting you are in the minority as far as economists are concerned?

Mr. DALIO. Oh, yes, definitely. Thank God for it.

Mr. LUKEN. You are not a one-handed economist are you?

Mr. DALIO. I am definitely a one-handed economist.

Mr. WILLIAMS. What is your answer?

Mr. DALIO. I would like to deal with the problem. What is the problem is the question, right.

Mr. LUKEN. Why don't we let you now present it in any form you would like to.

This is Mr. Raymond L. Dalio, president of Bridgewater Associates. He has submitted a statement, which, if there is no objection, will be received into the record of the subcommittee's proceedings.

Mr. Dalio, the floor is yours.

Mr. DALIO. Where we left off before, is the question what is the problem.

Since the 1950's, inflation has increased by a factor of 5, interest rates have quadrupled, the unemployment rate has tripled, and economic growth has ground to a halt.

Now, if we believe that the fundamental problem, is that there is excessive Government expenditures, excessive taxation, and that is the problem, and we believe that through Reaganomics or the shifts in sentiment in the country, we are moving to reduce that problem. We have to be extremely optimistic about our economy's future, because if we could have 2-percent inflation in the fifties, 3-percent interest rates, 4-percent unemployment, in an economy which grew at 3½ percent a year in the fifties, why can we not have it in the eighties if we eliminate the problem?

I do not believe that that is the problem, and I do not believe the most important problem. It is not our fundamental problem.

If you take the administration's program, which is to reduce the size of Government from about 22 percent of GNP to 21 percent of GNP, there is not much optimism about saving the other 99 percent of GNP within that sort of program.

In reality, the biggest problem that we have is an economy which has the highest debt as a percentage of GNP since the depression years. In other words, we have a debt-burdened economy. That is number one.

Second, we have an extremely illiquid economy. There are different ways of measuring liquidity, but one means of measuring is taking the ratio of current assets to current liabilities of corporations. That ratio at 1.4 to 1 is the lowest on record. Liquidity is more reduced than at any time before.

Another measure of liquidity is the complexion of the corporate debt; 41 percent of all corporate debt is short-term debt. That means corporations have to pay back 42 percent of their debt structure in the next year or refinance that debt structure. So you have an economy where it is debt-burdened and it is illiquid.

Money has become tight. We can measure the tightness of money in a variety of ways. But real inflation growth has turned negative

as of 1979, 1980, and 1981. Real money supply growth declined; money became tighter during 1978, 1980, and 1981 than at any time since the 1929 period. Another means of measuring the tightness of money is real interest rates.

Mr. LUKEN. Could you define that?

Mr. DALIO. Real interest rates, meaning the interest rate minus the inflation rate. Real interest rates in 1981 reached the highest level since 1929. So money is tight.

Mr. LUKEN. In 1981?

Mr. DALIO. In 1981, and now they are higher than that. I am just taking the year of 1981 as a whole.

Mr. LUKEN. That was even with a high inflation rate.

Mr. DALIO. There was a much higher level of inflation rate. It peaked in 1979 at 14 percent, and has been coming down.

Mr. LUKEN. In 1981 we still had 11 percent?

Mr. DALIO. It depends whether you use the GNP deflator or not. If you do, basically 9-percent inflation.

So what you have is an economy which is debt-burdened, illiquid, and facing increasing tightness of money.

As a result of that condition, having a lot of debt, needing a lot of liquidity, being short of it, and having tight money policies, interest rates as a percentage of GNP have risen to the highest level since the depression years.

I would like to turn your attention to the end of my prepared statement where there is a graph. It is called chart 3, "Net Interest Divided by GNP." It is the first of the yellow sheets at the end of my testimony.

Net interest as a percentage of GNP has in 1981 reached the depression levels, in fact the 1930 level. In other words, the amount of money going to pay interest at the expense of economic growth has never been as high, except for the depression years.

Now, it is like a family. Our economy is like a family. Economists tend to make things too complex. But the economy is like a family which has a lot of debt, reduced liquidity, meaning very little money in the bank, reduced supply of money, meaning their income is going down, and a rising net interest expenditure.

Mr. LUKEN. The income in that figure of speech is the GNP?

Mr. DALIO. That is GNP.

Mr. LUKEN. What you are referring to, the family's income is going down——

Mr. DALIO. The family's income is money supply, the amount of money coming in, their supply of money is going down, real money supply growth has been going down since 1979.

Now, these opinions were essentially not shared by most economists who emphasize the post-World War II period in their analysis. In other words, the Federal Reserve does no significant research prior to the post-World War II period. Most economists base their economic assumptions on the post-World War II period. But if you go back over the last 200 years, you can see there were 15 depressions in the last 200 years, all caused by the same economic problems.

Now, what a depression is is a self-feeding liquidity crisis. It means that as the economy begins to go into a liquidity-motivated contraction, inventory levels are liquidated and borrowings in-

crease. That does not happen even in a recession. It is a reflection of the acute illiquidity. In other words, companies which can raise money by either liquidating inventories or increasing their borrowings do both. And as a result, interest rates rise while inflation goes down simultaneously. That is why the divergence.

Since the appointment of Paul Volcker, the inflation rate has gone from about 14 percent to about 5 percent, depending on what period of time we are going to look at, at the same time as interest rates, the prime rate went from 11½ to 16½ percent. That is not normal for recessions. It is on the other hand normal for depressions.

The Federal Reserve now is in a bind. They have made money too tight, reserves have been excessively restricted, and the problem that they will face as the economy expands is that money supply has to grow faster. There has never been a time when money supply has not grown faster in an expansion than in the preceding recession. That is because an expanding economy demands more money than a weak economy.

As the demand for money will grow that much more rapidly, it will cause money supply to grow and interest rates to rise simultaneously. You will see that particularly in July, the month of July we will begin with an explosion in interest rates and money supply problems, motivated by an increasing demand for money.

Mr. WILLIAMS. You are saying interest rates will go up in July?

Mr. DALIO. Interest rates have bottomed. And I think sometime this summer, probably before the fall, you will see a full-blown panic for liquidity, where assets will be sold regardless of cost and borrowings will increase regardless of price of money.

Mr. LUKEN. And what is that demand for money? What is motivating the demand? You said there was a big demand for money in the first quarter, and now we are going into it again, right? This is part of that cycle you are talking about, where business is demanding money because of its liquidity problems?

Mr. DALIO. OK. It is caused by a few things.

First, the way companies——

Mr. LUKEN. We are going to have more money out there because of the social security and tax cuts, are we not?

Mr. DALIO. But that will be borrowed right back. Whatever we are giving in decreased taxes is taken right back in increased borrowings. It is a wash.

Mr. LUKEN. You mean Government borrowings, private, or both?

Mr. DALIO. Government and private will collide in the months ahead.

Up until now corporations dealt with their cash flow problems by liquidating inventories—that is one way of raising money. In other words, if I do not buy more items but continue to maintain my sales, I get that money in but I do not have to pay it out for those inventories, I live off my inventories. They have done that and increased their borrowings during that period for cash flow.

Cash flow is motivated by the 30-percent fall in earnings which have taken place, corporate earnings have fallen by 30 percent over the last year. Cash flow being motivated by the fact that net interest as a percentage of GNP has risen, their interest rate bill went up in the middle of that. Cash flow being a problem because

they have a high fixed structure, cost structure, and they cannot cut back on their borrowings.

So they, over the last year, maintained a high level of borrowings for cash flow reasons, and they reduced their liquidity.

Now we are in a position where liquidity is more reduced and the economy is showing signs of stability. The signs of stability are more a curse than they are an opportunity in a sense because as the economy expands, the demand for money once again picks up. That causes money supply growth to accelerate that much more rapidly at the same time as it causes interest rates to rise. There has never been a sustained increase in economic activity which was not accompanied by a sustained rise in interest rates.

Except now, we have the prime rate at 16½ percent. When the economy has bottomed in June 1980, the 1980 fall in interest rates we were talking about, the prime rate stood at 11½ percent, 11 percent, to be more precise. That expansion created a demand for money which caused the prime rate to double in 9 months to 22 percent. We now have a 16½-percent prime rate and an economy which is more illiquid than it was in June 1980. So that in the months ahead you will see interest rates rise sharply, accompanied by a sharp rise in money supply growth.

Paul Volcker will give his testimony in July and will be losing on all fronts, because the only way the Federal Reserve can get down interest rates is to cause money supply to rise in effect by providing reserves to the system. And the only way that they can get money supply growth to go down is to drain reserves from the system, causing interest rates to rise. We have money supply growth exploding above their targets at the same time that interest rates are rising. There is not one thing to trade off against the other. So at the same time the fragility of the economy has never been worse.

We talk of the failure rate. Failure rate before the end of the year in this type of economic environment should approach 125 per 10,000, which is the 1930 level of failures, because companies can lose money for a period of time without going broke, but then there is a level of losses which causes them to go bankrupt.

So we have a deteriorating economic environment accompanied by rising interest rates and rising money supply growth. There is an inability to trade one off against the other.

Mr. LUKEN. I think you are making your point very clear. But I am wondering whether you are saying that the dire economic situation—the recession—is that due to any governmental forces other than the Volcker policies? I guess the real question I am asking, do you have recommendations, are there things that Government can do, and what are they?

Mr. DALIO. OK. Let me take your questions one at a time. Question No. 1 is what is it due to, particularly a growth in debt which was motivated largely by an excessively loose monetary policy prior to Paul Volcker's appointment, and that loose monetary policy kept interest rates low against inflation. And in that period of time, when interest rates were low against inflation, it is smart to borrow and buy, and stupid to save. We build a big debt structure.

Mr. LUKEN. Public and private?

Mr. DALIO. Private grew much faster than public debt. The fastest growing form of debt over the last 30 years has been mortgage debt. It is bigger than the Federal Government's debt.

In 1979, in order to fight inflation, we moved from an excessively loose monetary policy to an excessively tight monetary policy. As a result, liquidity was drained rapidly from the system.

Now we have an economy with by any measure the most reduced level of liquidity since 1929, and the choice is to reliquefy or not. Reliquefication, in other words, to provide all of those with enough money to avoid a bankruptcy crisis, to get housing starts up in the area of 1.5 million units, to get auto sales up in the area of 6½ to 7 million units, to get those industries in the black, to get the farm sector profitable, to get airlines and all of the various sectors that need to have an improvement in profitability, to allow corporations to reliquefy their balance sheets rapidly enough, meaning over the next few months, would take an explosion, a dramatic infusion of liquidity, which would cause an inflationary spiral.

Mr. LUKEN. So you are not recommending that.

Mr. DALIO. There is nothing that can be done. What you will see is the Federal Reserve over the next July, August, September period, attempting to both slow the rate at which interest rates and money supply growth grow together, and you will have in my estimation a bankruptcy crisis that cannot be avoided. The only things that can be done are, one thing that can be done to minimize this is one of the problems of the economy is those sectors of the economy that need it the most are the last to receive it. In other words, the housing and auto sectors, for example, are at the end of the line of those who will get liquidity. As liquidity goes into the system, corporations will use their balance sheets or rebuild inventory. In order to provide the entire system, all those standing in line who need liquidity, with enough liquidity so it gets to those who need it the most, and they need it the most because they are the last to receive it, that has an inflationary consequence that is also unacceptable.

There is one thing you can do, and that is unfortunately, believing in the free market it goes against my grain—you can change to some degree the rate at which it goes to those sectors.

For example, the Reagan veto of the housing subsidy, in effect, was in my opinion a mistake. You have to get money to those who need it most in order to avoid a bankruptcy crisis. And they are far in there.

Mr. WILLIAMS. We had a program in Youngstown, Ohio, where the local banking community got together and dropped interest rates on the purchase of a new car to 12.8 percent. In fact, the President spoke about it in one of his radio talks. In Youngstown, Ohio, we have 23-percent unemployment. They broke all records in auto sales. The auto dealers clearly show, with this 6-week program, that we have a pent-up economy out there that depends totally on interest rates—taking one of the worst areas as far as unemployment goes, 23 percent——

Mr. LUKEN. This was a 6-week program?

Mr. WILLIAMS. A 6-week program. People flocked into the dealerships to buy cars.

Now, how does that go in tune with your theory?

Mr. DALIO. In my opinion——

Mr. WILLIAMS. That the Fed maybe should not stick their neck out and drop interest rates to see if this is in fact the case, that we do have a pent-up economy. I am one who strongly believes we have to help the unemployed worker. I have a district that has 23 percent unemployment. But I am also one that believes there are 90 million people working in this country who are not buying anything because of interest rates.

Mr. CITRON. Mr. Williams, why was it continued beyond 6 weeks?

Mr. WILLIAMS. The banks obviously could not buy the money.

I am simply saying if Volcker and the Fed stuck their necks out, as you have implied was the case from the 1950's through 1979, we could possibly turn this around.

Mr. DALIO. No, you would not. You would have an inflationary explosion. It is like putting a seed in dry ground that has not been watered.

Mr. WILLIAMS. You are saying there is no hope.

Mr. DALIO. There is no hope. It is a hard reality. But it is like everyone in this room will die.

Mr. WILLIAMS. I just think it is worth a chance. Is it not worth a chance, if there is no hope?

Mr. DALIO. It is not a matter of chance. It is a matter of numbers.

It is like putting a seed in dry ground, and it does not rain. So that seed does not begin to sprout. Nothing happens. Then all of a sudden you provide it with the rain and you will see rapid growth. That would cause an inflationary spiral which in and of itself will create a crisis.

Mr. WILLIAMS. But it also removes a couple of things. It removes our need to subsidize the auto industry because they are getting orders.

Mr. DALIO. Why has inflation gone down? It has gone down because real interest rates have stayed high, which has caused inventory liquidation, caused a fall in the demand for finished goods; it has caused the strength in the dollar which has made our imported goods, particularly oil, cheaper. It is all of those ingredients have made a falloff in inflation. If you inject enough liquidity to avoid a crisis, which means you have to inject liquidity rapidly into the system, because we cannot keep things just as good as they are for the next year, you will reliquify the economy in the next 3 months and would cause an inflationary explosion. So that is the tradeoff. The tradeoff literally is between hyperinflation and an economic collapse.

Mr. WILLIAMS. I guess I might be willing to make that.

[Mr. Dalio's prepared statement with attachments follows:]

PREPARED STATEMENT OF RAYMOND T. DALIO, PRESIDENT, BRIDGEWATER ASSOCIATES, INC., WILTON, CONN.

Most economic statistics now show that the economy's rate of decline is now slowing. Real GNP in the second quarter of 1982 appears to have turned up by 6 percent. Housing starts, auto sales, new orders for consumer and durable goods, initial claims for state unemployment insurance and a whole host of other statistics all paint a similar picture of an economy about to expand.

While disagreeing on how many months away from full recovery we are, the vast majority of economists agree that we are in a recession which is approaching bottom.

The purpose of my testimony is to make it as apparent to you as it is to us that rather than being in the late stages of a recession we are now in the early stages of a modern day version of a depression. This depression, like all others, will more adversely affect small businesses than other segments of the economy. (The modern day depression is essentially the same as the traditional depression except with greater government involvement.[1])

Contrary to popular belief, a depression is not simply a more severe version of recession—it is an entirely different type of degenerative process. If depressions were simply more severe versions of recessions and one just used measures of severity such as the rate of unemployment or the rate of fall in GNP to differentiate between them, then there would be no means of distinguishing the early stages of a depression from the late stages of a recession as they are both comparably severe. However, by understanding the processes that cause depressions to become more severe than recessions, it's easy to distinguish between them. This is the primary purpose of my testimony.

Tragically, the depression process is today even more of an enigma than it was in the thirties. Ask any omniscient economist you happen to know, and chances are he couldn't explain what turned the strongest economy on record [2] into the most depressed. The Great Depression wasn't set off by war or drought. There were all the elements to make the economy expand and yet it stagnated. Why didn't the idle factories simply hire the unemployed to utilize the abundant resources in order to produce prosperity? [3] Popular explanations such as "stock market speculation and insufficient government safeguards" simply reflect the extent to which today's economists misunderstand what happened.

Unfortunately, the word depression is now used more sensationalistically than diagnostically. Most economists avoid it believing it's not in keeping with their image, while those with a sensationalistic flair overuse and abuse it. The purpose of this testimony is to examine the depression process in a non-emotionally charged way.

Admittedly, my firm's perspective is different than most economists. This is essentially because we view all recorded economic history as continuous while others view the post World War II economy as distinct from its earlier past. In other words, since we built our models to fit the 1800 to 1982 period and other economists built theirs to fit the 1947 to 1982 period, we came up with significantly different results. Which approach is better? That depends on whether you believe understanding the pre-World War II economy is misleading or invaluable.

We find it relatively easy to understand what's happening to the economy simply because we've seen it so many times before. By contrast, economists with a post World War II perspective never saw interest rates this high in relation to inflation (the last time was 1929). They never studied the behavior of an economy this debt burdened (the last time the ratio of debt to GNP was this high was in the last depression) and don't understand the implications of having net interest represent such a high percentage of GNP (the ratio of net interest to GNP is now 7.7 percent which is significantly higher than at any other time in the post World War II period yet identical to 1930's level). Today's economists are about as familiar with depressions as today's physicians are with long dormant plagues.

Since 1800 there have been fourteen major depressions in the U.S. (each briefly explained at the end of this report). Virtually all progressed in essentially the same way. This is what we call the depression process. This process can be segmented into four phases. In Phase 1, the economy becomes debt burdened and illiquid which makes it depression prone. This leads to a liquidity crisis (Phase 2) which culmi-

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[1] Increased government involvement has the effect of slowing the degenerative process essentially by preventing panics and uncontrollable economic shocks. For example, today's orderly liquidation of savings institutions is certainly less panic provoking and is preferable to the antiquated method of having these institutions slam their doors and depositors lose their money. By preventing the bankruptcies of Chrysler, Poland and New York City not only did the Federal Government prevent the direct shock consequences of these failures, but thus far they have averted the traditional "flight for security" which dries up capital flows to—and contributes toward the failures of—other troubled borrowers. Additionally, the Federal Reserve has on several occasions prevented sharp increases in Fed funds and other short term interest rates (hence significant inversions in the yield curve) by providing liquidity at a rate of over $2 billion per week. Unfortunately, the bankruptcy problem is now spreading to the mainstream of the economy, hence beyond their control.

[2] During the twenties real GNP grew by an unparalleled 47 percent.

[3] The answer is that while everything else was in surplus, there was a shortage of liquidity.

nates in a panic (for liquidity). Panic signifies the transition to Phase 3 or economic failure at which time the economy is in a self-feeding contraction. After this contraction runs its course the depression enters what we call Phase 4 or economic stagnation.

As you will see, this depression has advanced to the end of Phase 2. Having come this far does not make it inevitable that we'll progress to Phases 3 and 4. Given the tools now available it's theoretically possible to avoid economic failure and stagnation. It is, however, extremely improbable that those vested with the authority to use these tools will do so with the necessary precision to prevent the depression from advancing. Having watched them bring the economy to the brink of failure, it's our assessment that rather than being part of their grand scheme, this deterioration is the result of their misunderstanding what's now happening in the economy.[4] In this testimony I will carefully explain the depression process, how it is now affecting our economy and what can be expected as a result.

PHASE I—THE DEPRESSION PRONE ECONOMY

The most fundamental difference between a recession and a depression is that a recession is self-correcting while a depression is self-feeding. Essentially, this is because recessions create liquidity while depressions destroy it. In a recession, the "demand" for money falls relative to the "supply".[5] As a result, interest rates fall and the economy reliquifies. However, in a depression the "supply" of money falls relative to the "demand". As a result, interest rates rise and liquidity is reduced. The depression feeds on itself because, unlike the recession, economic activity and liquidity fall together each reducing the other. Therefore, a depression prone economy is one in which the demand for liquidity is highly inelastic (i.e isn't easily reduced) while the supply of liquidity is severely restricted. The depression process typically begins when, (1) debt is a high percentage of GNP, (2), liquidity is severely reduced, and (3) money is tight. As a result, (4) the amount of money which goes to debt service at the expense of economic expansion reaches a high percentage of GNP. All of these conditions now exist:

(1) *Debt is a high percentage of GNP.*—As shown on Chart 1, the ratio of total debt to GNP has surpassed the 1929 level and is approaching the 1930 level. The only time the debt to GNP ratio was higher was when GNP was collapsing in the last depression (i.e. the big jump in the chart which took place from 1930 to 1933 developed in Phase 3 when GNP tumbled).

(2) *Liquidity is severely reduced.*—Liquidity can be measured in a variety of ways. On the basis of any measurement, the economy's liquidity is now more reduced than at any time since the 1929–1934 period. Corporate liquidity as measured by the ratio of current assets to current liabilities at 1.4, is the lowest on record. Adding to the strain on corporate liquidity is the fact that the percentage of corporate debt which is short-term is the highest on record (42 percent). Therefore, not only are corporations illiquid, but their demands for liquidity have never been more inelastic. Additionally disconcerting is the fact that the ratio of loans to deposits at commercial banks has risen to around 80 percent, which is the highest level since 1929 (see Chart 2). As a result, except for 1929, these institutions have never been more exposed to an outflow of demand deposits, a severe inversion in the yield cure and a surge in loan defaults.

(3) *Money becomes extremely tight.*—Existing tight money conditions are reflected in a variety of statistics—for example, as shown on Chart 4 the yield curve has been more severely inverted in the 1979–1982 period than at any time since 1928–1929 and has been this way for the longest period of time since the turn of the century. As shown on Chart 5, the last time real interest rates were as high as they are today was 1929. Real M2 growth has been falling since 1978—the longest period of time since the thirties. By any measurement, money is now tighter than at any time since 1929.

(4) *The percentage of GNP which goes to net interest payments at the expense of economic growth rises to abnormally high levels.*—As shown on Chart 3, for the first time since the last depression net interest as a percent of GNP has reached nearly 8 percent (the 1930 level).

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[4] There exists a faith, which in our estimation is misplaced, that with the enormous resources of the Government at their disposal, those in power have a better understanding of what makes the economy tick. Unfortunately, economists inside Government aren't any better informed than economists outside, as exemplified by those who move, back and forth (such as Alan Greenspan, Alfred Kahn and Walter Heller, to name a few).

[5] While, by definition, supply and demand must be equal, we are defining "supply" in terms of units sold, and "demand" in terms of dollars expended.

In summary, our economy has all the attributes of a depression prone economy.

PHASE II—LIQUIDITY CRISIS

Any economy with high fixed costs and reduced liquidity is susceptible to a liquidity crisis. Businesses can raise liquidity by either increasing their borrowings or reducing their inventories. In expansions they typically increase both borrowings and inventories, while in recessions they typically decrease both. However, in the early stages of a depression, (5) acute illiquidity causes inventories to be liquidated at the same time as borrowings increase, resulting in (6) falling inflation while interest rates rise, and (7) money supply growth increasing while GNP falls (i.e., the velocity of money declines).

As explained below, the economy is now in the last stages of Phase 2:

(5) *Acute illiquidity causes inventories and investment assets to be liquidated at the same time as borrowings increase.*—In the first quarter of 1982, manufacturing and trade inventories fell at the fastest rate on record, while corporate borrowings increased also at the fastest rate on record. While this activity is not normal at the end of a recession, it is typical of the early stages of a depression. All investment assets have of course been falling since 1980.

(6) *The simultaneous selling of inventories and increasing of borrowings causes inflation to fall while interest rates rise.*—Since the appointment of Paul Volcker in July 1979, 14 percent inflation has evaporated to around 5 percent while the prime rate increased from 11½ percent to 16½ percent. While extremely high real interest rates are abnormal at the end of recessions, they're typical at the beginning of depressions.

(7) *Money supply growth increases while GNP falls (i.e. the velocity of money declines).*—In the first quarter of 1982, while M1 grew at an annualized rate of 10 percent, current dollar GNP fell by .6 percent and real GNP fell by 3.3 percent. Thus, the velocity fell by 10 percent, which is the fastest quarterly fall on record and compares to the 1929 to 1930 fall of 9.6 percent.

The depression is now at the end of Phase 2. While Phase 2 typically lasts around 6 months and culminates in a panic for liquidity, thus far the Government has succeeded in preventing a liquidity panic and in turn the transition to Phase 3. As a result, over the last 2 years there has been a slow deterioration of the economy in Phase 2. However, the degenerative process is now passing beyond the Government's control. At this point it would take a massive reliquification effort by the Federal Reserve to simultaneously allow the economy to expand while interest rates fall, which is what is needed to prevent the acceleration of failures among construction, thrift, auto related, airline, farming, mining, lumber and numerous other durable goods industries. Therefore, it appears that we are only a few months away from economic failure.

PHASE III—ECONOMIC FAILURE

The depression process advances from Phase 2 to Phase 3 when the economy moves from gasping for liquidity to failing for lack of it. Phase 3 is the painful stage when the debt burden is eliminated through loan defaults and failures.

In the early stages of Phase 3, liquidity continues to be reduced but unlike Phase 2 this is the result of businesses failing rather than borrowing to stay alive. While late in Phase 2 the panic for liquidity causes the yield curve to invert sharply and an outflow of demand deposits from commercial banks which in turn restricts their ability to lend, early in Phase 3 the resulting (8) defaults cause writeoffs which reduce bank capital and therefore further constrict their lending abilities. Unlike Phase 2 in which borrowing is high, borrowing falls in Phase 3. The willingness as well as the ability to lend is reduced. The high failure rate makes lenders extremely risk averse, which further reduces the flow of funds to those who most need it, in turn increasing the failure rate. Loan writeoffs and reduced borrowings are reflected in (9) a fall in money supply (which, unlike Phase 2, declines together with the velocity).

In Phase 3, the debt/GNP ratio and net interest to GNP ratio continue to rise. However, unlike Phase 1, when this results from debt increasing faster than GNP or Phase 2 when it results from debt rising while GNP falls, in Phase 3 this ratio increases as debt and GNP both fall, with GNP falling faster. Increases in these ratios reflect the increasing burden of the debt which in turn causes failures to increase. In other words, Phase 3 is when the economy is in severe contraction (observe the 1929 to 1932 period in Charts 6–9). The end of Phase 3 and the beginning of Phase 4 is signalled when (10) GNP stops falling faster than debt and the ratio of

net interest to GNP begins to fall. As you can see by looking at Charts 1 and 3, in the last depression Phase 3 ended and Phase 4 began in 1933.

PHASE IV—ECONOMIC STAGNATION

In many ways Phase 4's attributes are exactly the opposite of Phase 1's. The demand for money is extremely reduced as a result of economic stagnation. As a result, for the first time in the depression (11) short term rates are extremely low in relation to long term rates and interest rates are low in relation to inflation. The massive inventory liquidation which took place in Phases 2 and 3 leads to (12) an extremely low inventory/sales ratio. The reduced level of debts, low real interest rates and an upward sloping yield curve stimulates (13) final sales growth led by durable goods orders, auto sales (see Chart 8) and housing starts (see Chart 9). (14) Unemployment, although extremely high, for the first time in the depression begins to fall. As GNP begins to increase (15) for the first time in the depression process the debt/GNP and net interest/GNP ratios begin to fall.

Although the economy expands and economic conditions improve in Phase 4, the economy is still depressed. We consider the economy in a depression until real GNP exceeds its previous high.

ECONOMIC ACTIVITY

It's simply a matter of commonsense that the economy cannot sustain a recovery. There are few things more apparent to the student of economics than the fact that interest rates rise and money supply growth increases when the economy expands. Since it takes more money to finance an expanding economy than a contracting one, in an expansion borrowings increase causing both interest rates and money supply growth to increase. For example, when the last recession ended in June 1980 the prime rate was at 11 percent and M1 was declining at an annual rate of 3.2 percent. During the ensuing recovery, borrowings increased by over 26 percent. As a result, the prime rate doubled to 22 percent and M1 grew at an annualized rare of over 12 percent.

Despite the severity of this contraction the prime rate now stands at 16½ percent and M1 is growing above the Fed's targets. Since any increase in interest rates would throw the economy into a tailspin and the Fed tells us that if M1 doesn't fall back to its targets they'll further restrict reserves, there's not much room for optimism about a recovery. In order for the economy to sustain a recovery—in other words surpass the first quarter of 1981 peak in real GNP (i.e. $1,501.9 billion)—the Fed would have to immediately make a 180 degree shift in policy (from extremely restrictive to extremely stimulative) and, given their policy statements and open market operations, it's our judgment that will not.

However, the economy is now groping for a bottom. More specifically, interest rate sensitive sectors of the economy are stabilizing around these disastrously low levels (e.g. housing starts around 1,000,000 units, auto sales around 6.0 million units and durable goods orders around $80 billion) while non-interest rate sensitive industries (e.g. services, electronics and defense) are expanding. The first quarter of 1982's fall in real GNP was not the result of a slowing of final sales; it was entirely the result of inventory liquidation which is now slowing. We are therefore projecting a modest upward turn in June which will show up in the form of about 1 percent growth in real GNP in the second quarter of 1982. Rising interest rates will in turn choke off the recovery. Unlike the third quarter of 1980 to the first quarter of 1981 expansion which lasted three quarters in length, was 3.6 percent in magnitude and took real GNP 1 percent above its previous peak. This expansion will last only one quarter in length, extend less than 1 percent in magnitude and not surpass the previous peak. Thus, rather than a recovery, it will be a minor correction in the economy's tumble. In fact, it will be this growth which will precipitate the liquidity crisis which will push the economy into Phase 3.

Over the next several months the Fed will be faced with accelerating money supply growth and rising interest rates. Some critics will then argue that interest rates are rising because the Fed has lost control of money supply growth and inflation fears are being rekindled, while others will argue that the Fed should inject liquidity to force rates lower. As we believe that the Fed, the administration and the public are more attuned to the first of these philosophies, we cannot conceive of their injecting the enormous liquidity needed to finance an expansion accompanied by falling interest rates which, while preventing a panic for liquidity, would also rekindle inflation. We therefore expect that there will be a modern day version of a panic sometime around Labor Day and severe contraction well into 1983.

In particular, we are projecting real GNP to fall at an average annualized rate of 12 percent during the third and fourth quarters of 1982. We are therefore sticking to our projections (made well over a year ago) that 1982's real GNP will fall 4–6 percent below 1981's and that this will be part of a contraction which will run 10–12 percent peak to trough. In brief, unemployment will average 11 percent in 1982, reaching over 12 percent by year end. The average work week will fall to around 30 hours. By year end, housing starts and auto sales will fall to under 700,000 and 4.6 million units respectively while the failure rate will reach over 155 per 10,000.

FEDERAL RESERVE POLICIES

Our view that interest rates will be rising to new high levels this summer generally meets with the response, "As it is boldly apparent that rising interest rates would cause an economic collapse and as we are moving into a pre-election summer, it is inconceivable that the Federal Reserve will allow it to happen." To be blunt, it is our estimation that the Federal Reserve doesn't understand what's happening.

In studying post World War II economic statistics (they do little significant research concerning prior years), they observed that money supply growth, inflation and interest rates tended to rise and fall together. Thus, they concluded that by restraining monetary growth they would lower inflation and bring down interest rates. Since lower interest rates stimulate the economy, they further concluded that their tight money policies would lead to the optimal combination of low inflation, low interest rates and high economic growth. The pervasiveness of this philosophy is reflected in popularity of the notion that "lower money supply growth dampens inflationary expectations and in turn lowers interest rates."

However, when one studies the sources and uses of funds it becomes apparent that inflationary expectations exert virtually no influence on interest rates. Money supply growth, interest rates and inflation tend to rise and fall with the economy. In a weak economy the demand for money tends to fall (causing inflation to fall). When, over a year ago, we projected that "in 1982 we will see record high interest rates accompanied by deflation" we reasoned that "the only way significantly lower interest rates will accompany significantly lower inflation rates is if there's a depression. Or, put another way, if the supply of money is severely restricted, the only way interest rates can fall is if the demand for money tumbles,[6] and—given the Federal Reserve's monetary targets—that would mean a depression."

Inflation has been annihilated and still interest rates rise. Do supporters of tight money policies (to lower interest rates) acknowledge that they might be wrong? No. They argue that interest rates remain high because the marketplace doubts the Federal Reserve's willingness to stick to these policies. It's like bleeding the economy with leeches—an absurd treatment which is draining the economy of liquidity leading to its further weakening, reinforcing their conclusion that further treatment is needed.

INTEREST RATES

In our opinion, interest rates must rise significantly near term (over the next 6 months) and must fall significantly longer term (over the next eighteen months).

Virtually every sector of the economy is eagerly awaiting interest rates to fall in order to borrow—families are waiting to buy houses and cars, businesses are waiting to reliquify their balance sheets and replenish their depleted inventories and the Government isn't waiting. Recent high private and public borrowings have resulted from need rather than desire. The unanimity of sentiment that interest rates will fall has thus far restrained non-essential borrowings. As the economy shows signs of strengthening loan demand will increase, interest rates will rise and failures will increase. As failures increase lenders will become more risk averse, lending only to those who are considered low risk. Thus, the flow of funds to borrowers who need it the most will be cut off, further increasing the failure rate. Small businesses will be the most adversely affected at they will fail fastest and carry less clout with their bankers. For example, most small businesses will not receive the type of treatment enjoyed by Chrysler, Poland, Romania, Argentina, Mexico and other large, poor credit risks. To the contrary, as lenders maintain the flow of funds to the big foreign and domestic borrowers, there is less money left to be loaned to those businesses which constitute the mainstream of the American economy. The only way there can

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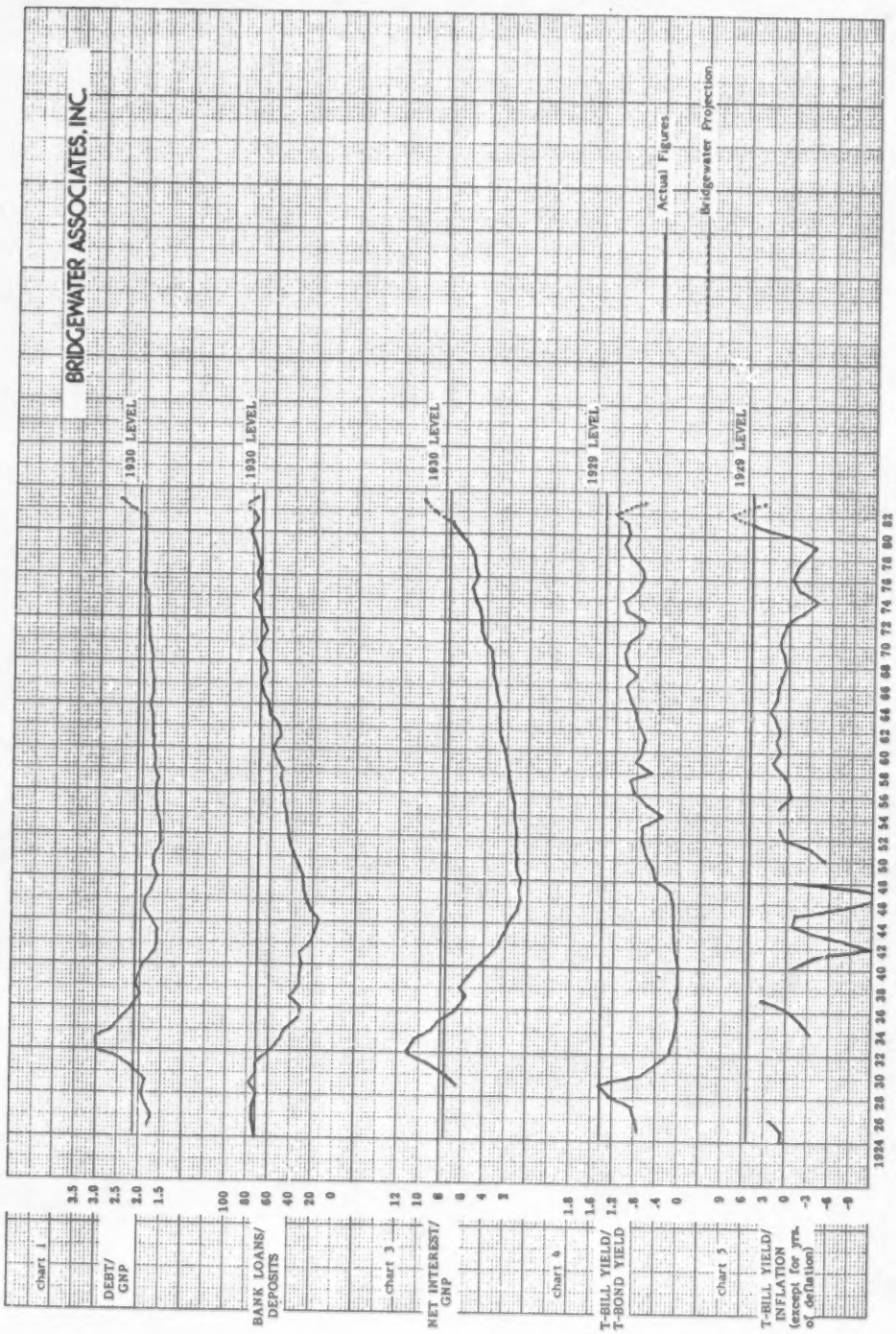
[6] More precisely, when only marginal growth in the money supply is allowed, interest rates rise more sharply causing debt service payments to increase. Thus, this marginal money supply growth is used to satisfy increased debt service payments and inflation leaving nothing to finance real GNP growth.

be a sustained fall in interest rates is if there is such flooding of the system with liquidity so as to finance a sustained economic expansion which is accompanied by a sustained fall in interest rates (which would result in accelerating inflation). We would assess the probability of this as less than 5 percent. While it is possible to have a brief fall in rates motivated by a budget compromise or a few weeks fall in money supply, the direction of interest rates over the next several months is clearly up. My concerns cannot be overstated. It would not be an exaggeration to say that I fear for the survival of our economic system as we know it.


BRIDGEWATER ASSOCIATES, INC.
Chart 1
DEBT/ GNP
1930 LEVEL
BANK LOANS/ DEPOSITS
1930 LEVEL
Chart 3
NET INTEREST/ GNP
1930 LEVEL
Chart 4
T-BILL YIELD/ T-BOND YIELD
1929 LEVEL
Chart 5
T-BILL YIELD/ INFLATION (except for yrs. of deflation)
1929 LEVEL
Actual Figures
Bridgewater Projection
1924 26 28 30 32 34 36 38 40 42 44 46 48 50 52 54 56 58 60 62 64 66 68 70 72 74 76 78 80 82

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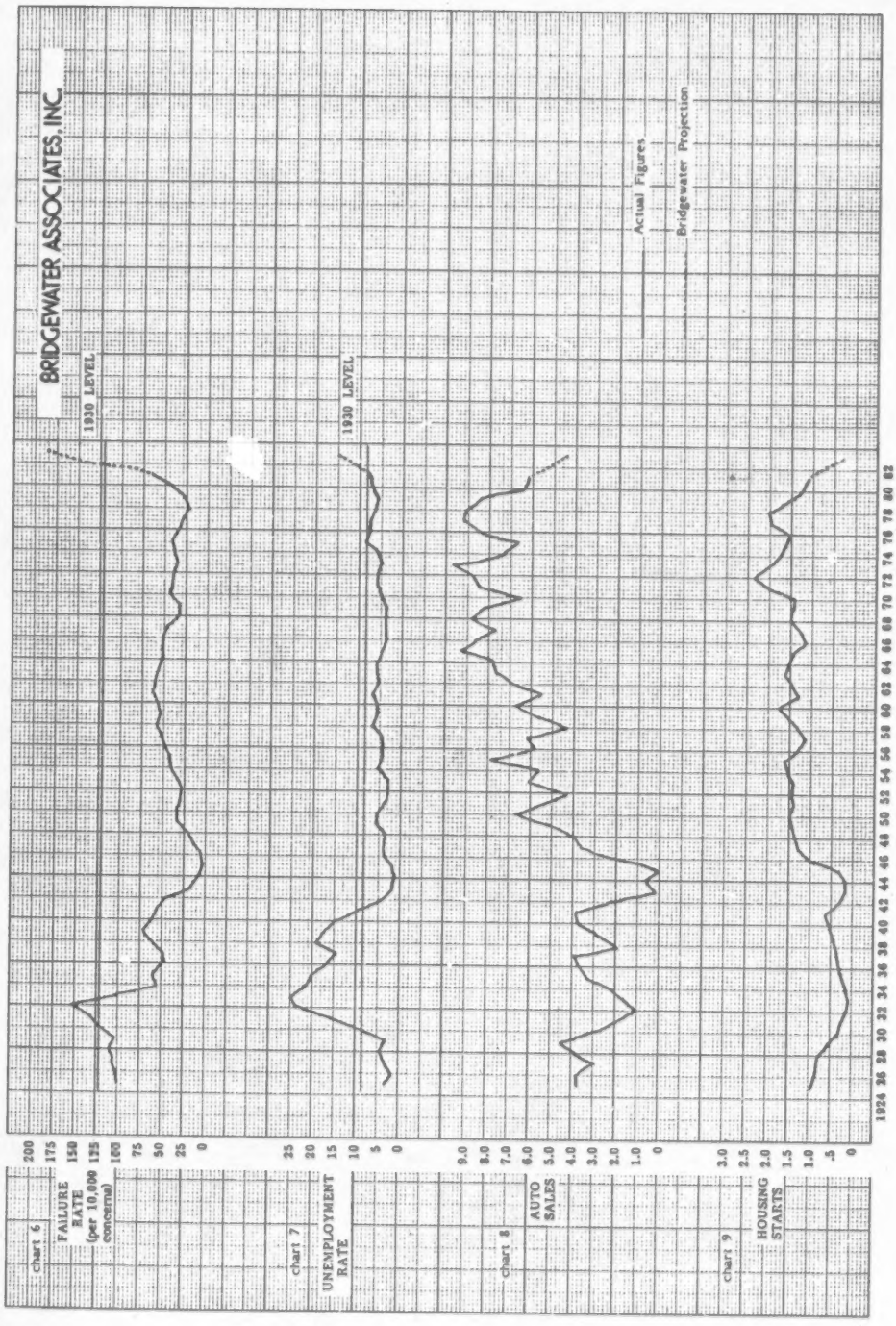
BRIDGEWATER ASSOCIATES, INC.
Chart 6
FAILURE RATE (per 10,000 concerns)
1930 LEVEL
Chart 7
UNEMPLOYMENT RATE
1930 LEVEL
Chart 8
AUTO SALES
Actual Figures
Bridgewater Projection
Chart 9
HOUSING STARTS
1926 28 30 32 34 36 38 40 42 44 46 48 50 52 54 56 58 60 62 64 66 68 70 72 74 76 78 80 82

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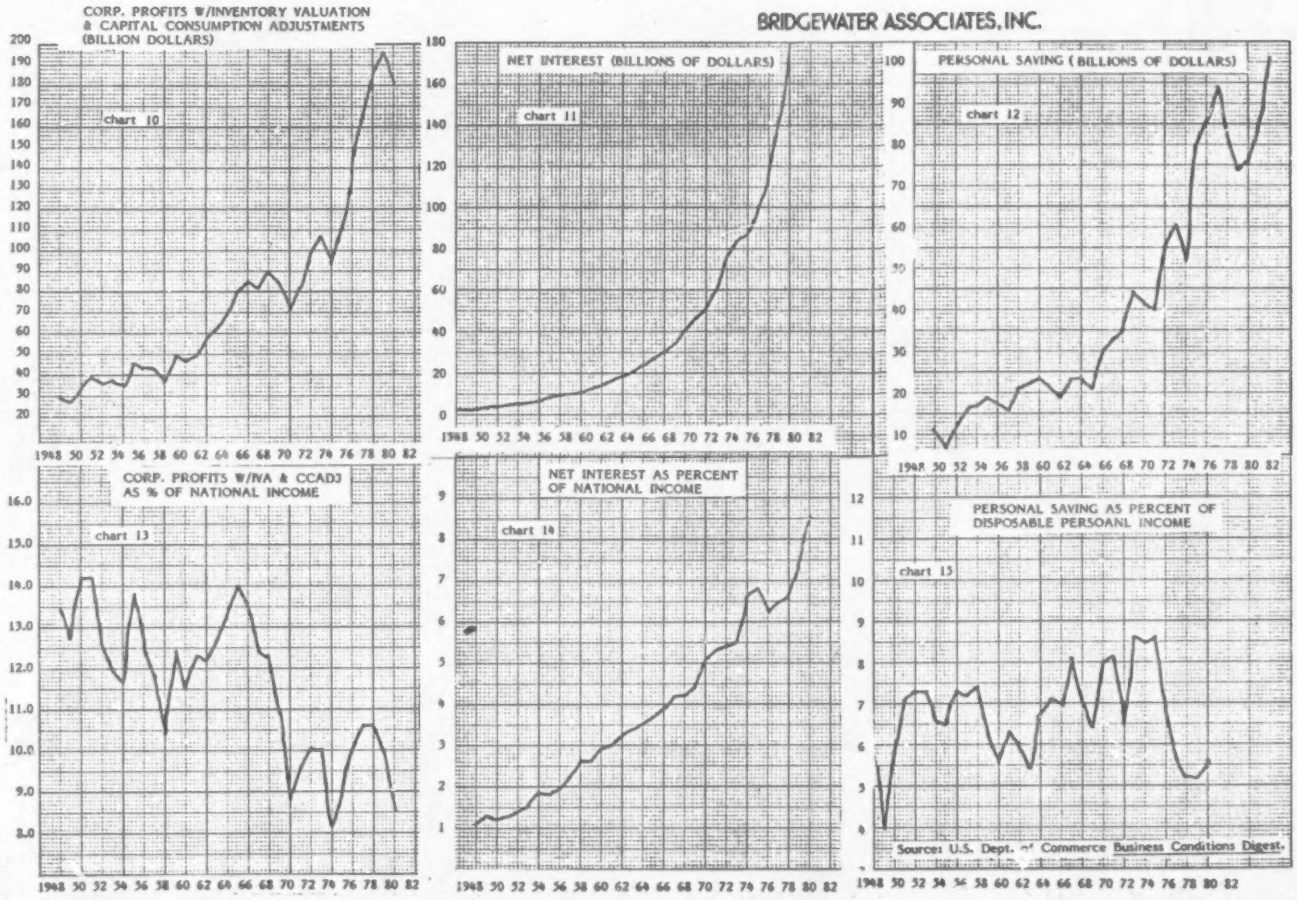
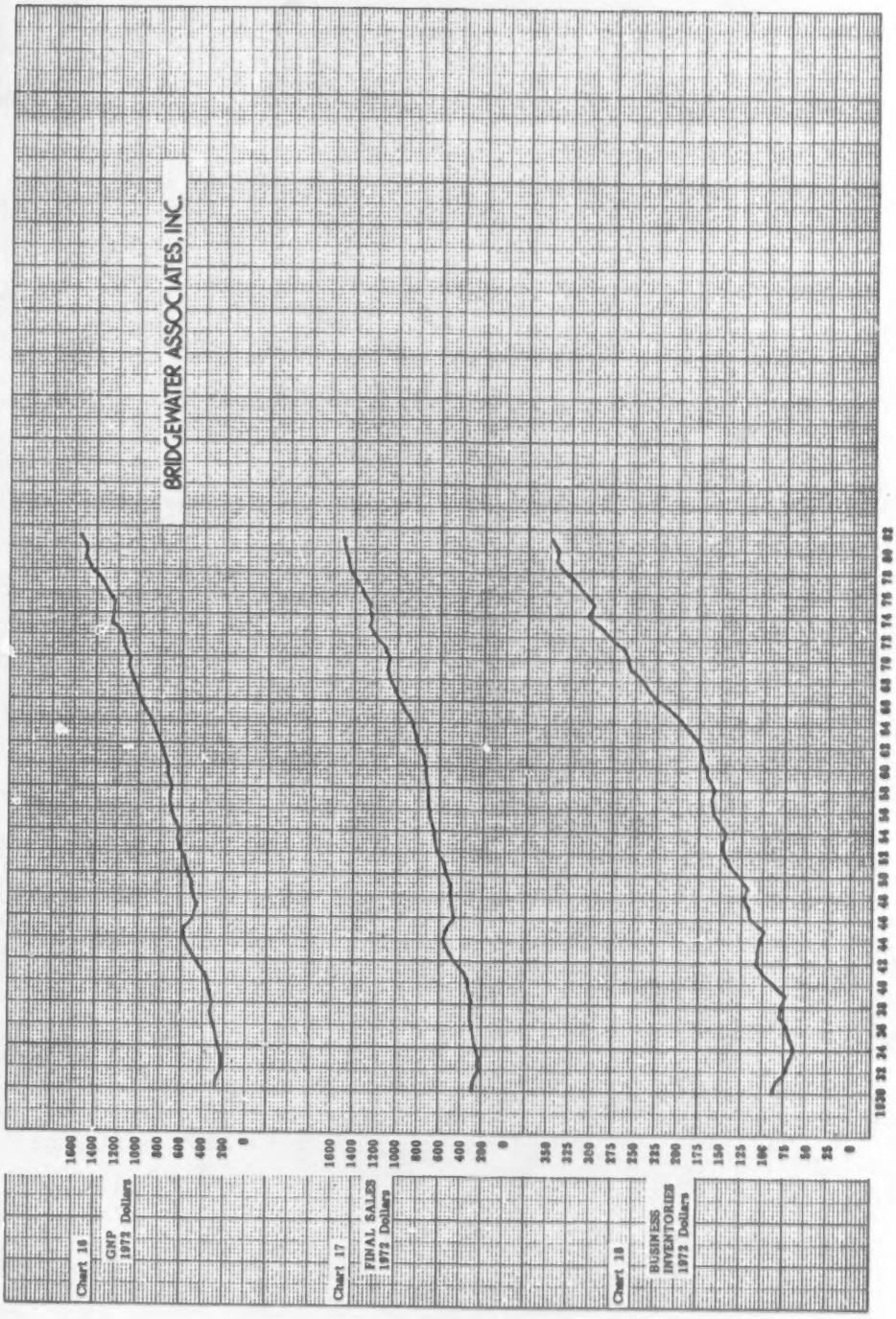

BRIDGEWATER ASSOCIATES, INC.
CORP. PROFITS W/INVENTORY VALUATION & CAPITAL CONSUMPTION ADJUSTMENTS (BILLION DOLLARS)
chart 10
NET INTEREST (BILLIONS OF DOLLARS)
chart 11
PERSONAL SAVING (BILLIONS OF DOLLARS)
chart 12
CORP. PROFITS W/IVA & CCADJ AS % OF NATIONAL INCOME
chart 13
NET INTEREST AS PERCENT OF NATIONAL INCOME
chart 14
PERSONAL SAVING AS PERCENT OF DISPOSABLE PERSOANL INCOME
chart 15
Source: U.S. Dept. of Commerce Business Conditions Digest.



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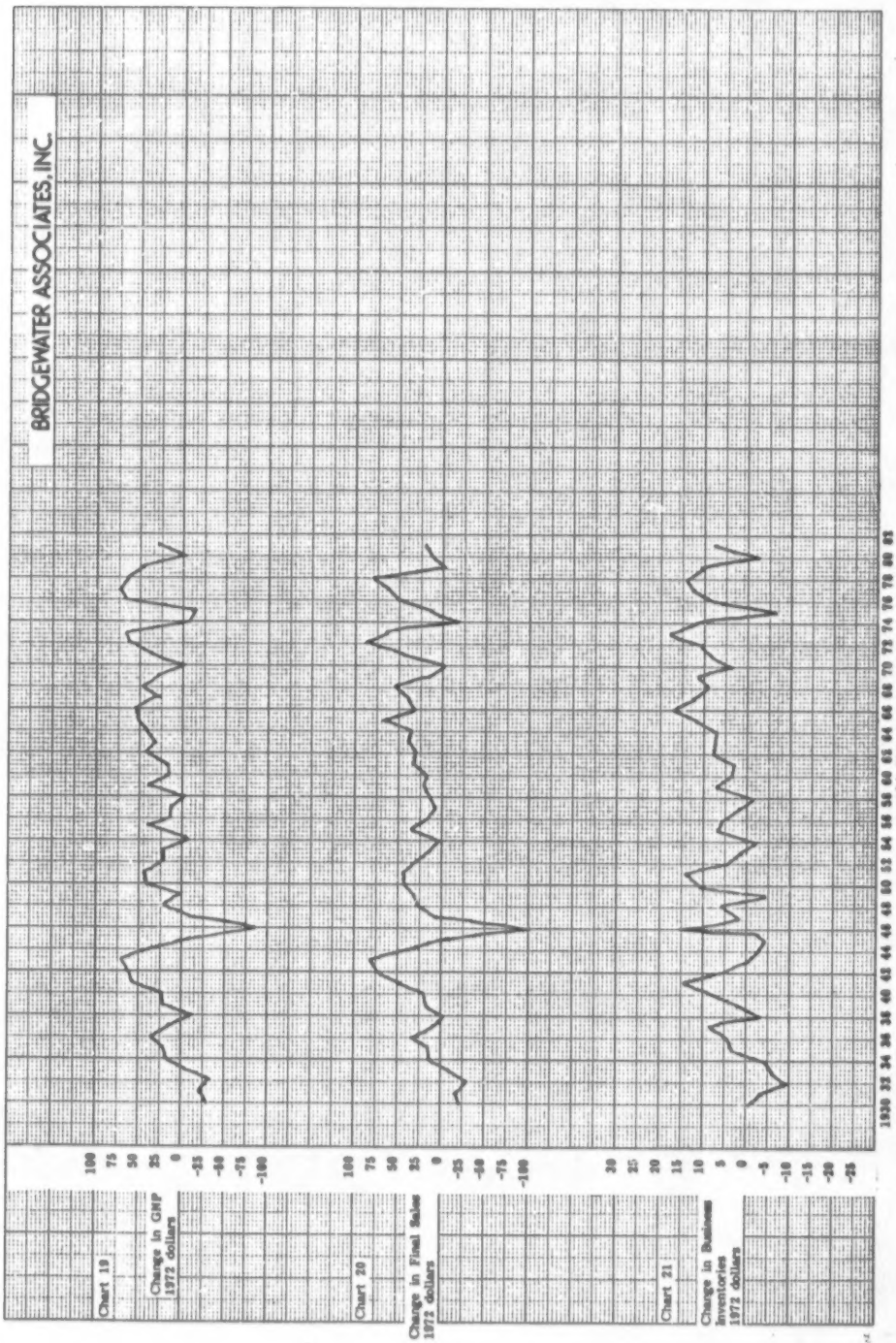

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Mr. LUKEN. Mr. Schochat, we interrupted you before. And I think we are going to be winding this up in a little bit.

You want to get into this buzz saw?

Mr. SCHOCHAT. I am not an economist. I have my own opinions as to—just from a sociological and economic standpoint—why there are certain failures. I think specifically in the small business area we are talking more macroeconomics here. I think competition was mentioned. I think it is a key ingredient, especially foreign competition.

I think in the last 40 years, even 20 years, business has become more of a complex entity—the technology involved, the management that is necessary, the depth of thinking that is necessary to make a business successful is much more complex. I think people just cannot keep up.

I think you have also a different business attitude than you did 20 years ago, different social attitude. You have less of a stick-to-itiveness, as I call it. I think people tend more to give up than to keep it going, and keep fostering, and looking at all avenues. I think the various social programs that have been developed have caused that lessening of that.

Mr. LUKEN. There are no more alternatives.

Mr. SCHOCHAT. And then you have the economic factors, which is inflation and, of course, interest rates. So, you mix all that together and you get a cauldron in which the solutions are very, very difficult to get at.

I think what small business needs is a lot of handholding, a lot of technical assistance.

Mr. LUKEN. I was going to say—what Mr. Dalio has said when we pressed him for a suggestion, and we empathize with him, at least I do, and I think Mr. Williams also indicated he does, too, because people are always looking at us and say don't just stand there, do something—despite the fact that there are a lot of conditions over which we have very little or no control. So he said we have committed mistakes and we are suffering the consequences, and we cannot undo all those mistakes. Some other people are talking that way, too.

We asked him what can we do, and he said, in effect, target some of that assistance.

Mr. DALIO. Absolutely.

Mr. LUKEN. And that is what you are saying, also. You are saying target it. And that is what Mr. Citron is saying. You are saying target it. And when we do, we run the risk of being accused of bailing somebody out. But those are ideologues who continually use those terms to generalize.

We are saying target it. We are being specific about how we are going to target it. You are saying target it to small businesses. You have seen it work, you participated in it, and it has worked, the governmental processes, in targeting. Right?

Mr. SCHOCHAT. Certainly I would agree with Mr. Dalio that we ought to target it to construction and especially to residential construction, and to the automobile sector.

Mr. DALIO. And particularly small businesses.

What you will see over the next few months will more adversely affect small businesses than any other sector, in that I think that

as lenders begin to become more concerned, more fearful about the security of their loans, only those who are the most creditworthy will get loans. You are beginning to see the flow of money to those who are only considered the most secure.

You can see this expressed in the marketplace. For example, you can see the flow of funds—Treasury security yields are not rising as fast as CD yields. What will happen over the months as lenders become more concerned about their security and there is the flight for security, is the flow of money to those who need it the most will be cut off. And that will exacerbate the failure rate. That will be small business.

When we reschedule Poland's debts, or give aid to countries, or major companies like Chrysler, that is at the expense of the small business community. In other words, the money which goes to an Argentina, the money which goes to a Brazil, the money that goes to Poland or Romania, who are the big bad debts, or a Chrysler, and so on, who are the big bad debts, sometimes—not sometimes—is at the expense of money which goes to small business.

Mr. WILLIAMS. What would happen if we would write off the national debt?

Mr. DALIO. The national debt isn't the biggest problem. Although any reductions in the form of debt would be, of course, a reduction in the burdens.

Mr. WILLIAMS. Is it true we are the only country in the history of mankind that hasn't written off its national debt at least one time?

Mr. DALIO. And it happens in various forms. New York City, in effect, wrote off its debt by restructuring it.

Mr. WILLIAMS. That is what I am talking about.

Mr. DALIO. The problem is then you ultimately destroy the currency, because of the credibility that is lost. Who wants to loan somebody who has defaulted?

Mr. CITRON. May I ask Mr. Dalio one question. It is a supposition. Assuming Mr. Volcker resigned and you were appointed Chairman of the Board of Governors, what would you do?

Mr. DALIO. I know the nuts and bolts of this. What I would do is trade off now the evils of rising interest rates and expanding money supply growth. I would have, hopefully, a high level of stagflation rather than an inflationary spiral or an economic bust. But the chances of pulling that off are not very high.

At this point in time, the emphasis shifts back now to fiscal policy to provide the necessary organization, the necessary programs to deal with the bust. Monetary policy, because of the mistakes that were largely made, it implies there is providing of enough liquidity, which means an inflationary explosion, or not enough liquidity, which means a bust.

Mr. CITRON. Which way are you going to go if you are Mr. Volcker?

Mr. DALIO. What I would try to do is trade off the evils. That is exactly what he is trying to do now. You are seeing while money supply growth is running significantly above the Fed's targets, the Federal Reserve recently has made no attempts to reduce reserves. They have maintained a very loose monetary policy, particularly after the Drysdale affair, and given the fragility of the economy,

they have made it looser, and that is because the only way they can tighten monetary policy is to force up interest rates.

Mr. LUKEN. That is what they are doing. What would you do?

Mr. DALIO. That is at this juncture the only thing to be done. At this juncture, because of the mistakes——

Mr. LUKEN. So you would do what Mr. Volcker is doing.

Mr. DALIO. Yes. He made the mistake in 1979. I think if you sit him down here, he would admit—he set the targets for 3 years, and up until a few months ago he set his targets too low.

Mr. LUKEN. You would not under any circumstance feed the fires.

Mr. DALIO. All you are doing is trading off evils. It is how much——

Mr. LUKEN. All you are doing is giving us figures of speech when you say that.

Mr. DALIO. I am giving you hard reality.

Mr. LUKEN. We talk in those terms all the time, but we want to be specific about what you are going to do.

Mr. DALIO. What I would do is slow——

Mr. LUKEN. You wouldn't relax credit?

Mr. DALIO. I would definitely relax credit. And despite my relaxing credit—keep reserves, to be very specific—keep net borrowed reserves under $1 billion. I would therefore keep enough liquidity in the banking system, which will have the effect of causing inflation to rise, and despite my policies, interest rates will rise concurrently.

In other words, we are now in a sufficient bind that there is no way out because of past mistakes.

Mr. LUKEN. You wouldn't do what Mr. Volcker is doing.

Mr. DALIO. Right now——

Mr. LUKEN. You would let up some.

Mr. DALIO. Right now what Mr. Volcker is doing and what he has done over the last 30 days in my estimation is the only thing Mr. Volcker can do.

Mr. LUKEN. What is that?

Mr. DALIO. He has loosened monetary policy in an attempt to trade off rising money supply and rising interest rates. They both will rise together. And to slow the rate at which they both rise together.

Mr. LUKEN. On that point, I think you have given us an answer. And I will say that it is—and I am sure Mr. Williams would agree with this—it is a treat to get out of Washington for a number of reasons. One reason is that if we were sitting in Washington conducting a hearing like this, it would take us at least 2 days to get as much testimony as we have here in the space of 3 or 4 hours, because we would be constantly harassed by the bells and being carted off to vote and do other sorts of things, and witnesses would be sitting around instead of continuing to participate as you have, done so marvelously.

I think you have been so very helpful. But you have also made it, as far as I am concerned, a very enjoyable process.

I really have made all of the statements that I intend to.

Mr. PIERSON. Mr. Chairman, if I could just ask a question. Mr. Snyder and I are small businessmen. We face this problem differ-

ently than an economist does. We pay the high interest rates that put Mr. Snyder out of business. It has put a serious crimp in our business. For the first time in history, the business I am in, which is a substantial business, got an income tax refund. That is not right for our kind of business. And it was due 100 percent to high interest rates. We got away from that subject a little bit.

Mr. Citron mentioned he kind of accepts deficits and high interest as part of the way of life. I don't think we can really accept those things as part of the way of life.

Mr. Dalio, as an economist, has a view. I find in talking to economists there is no majority. Everyone seems to have a little different angle, more based on history than the future.

But what I cannot understand, and I would like to ask one question of an economist. This country got along great with a usury rate of 6 percent for generation after generation. We have got locked into variable interest rates, which is a pretty new thing. We never had this. When you borrowed money at the bank or anywhere else you said I am going to pay 6, 8, or 10 percent, or 5 percent, or 1 percent, which we did at one time, and that is what it was. But now when you borrow that money, you are locked into a variable rate. I submit small business people have a lot of problems—some of us are incompetent, some don't get enough advice, some of us spend too much money.

But today we are locked into a situation that once you go to the bank and make that loan, and sign those papers, you don't know what you are going to pay in the future. I have seen it, in some of our business, triple. And no business can afford it. And I say that the FRB is doing something wrong to allow that to exist. And if the problem is not addressed, you are not going to help small business.

Mr. LUKEN. That is a good question.

Mr. SCHOCHAT. I don't know if I can respond to that directly. But I can respond to it only through a track record and also experience that has occurred in the last 2 or 3 years. The consequences of a locked, fixed interest rate, I think, is no longer reality based on the experience of a whole industry which is being wiped out slowly, namely the savings and loan industry, which is a real economic factor.

I know it has nothing to do with you as a small businessman.

Mr. PIERSON. They are being wiped out by high interest rates.

Mr. SCHOCHAT. Yes. Because their portfolio is in a fixed interest rate environment, and based on the fact they don't have that flexibility to go into a variable rate, as now they have in the last 4 or 5 years, causes them great concern. The fact that it is not a floating rate is of great consequence. So I am not saying that deregulation doesn't suffer its consequences. You can certainly see what happened to the airline industry. But certainly I think in the banking industry, and how it impacts on business, I think that is an evolutionary process and you have to live and learn. You have to reach certain plateaus. You might sink, you might go up.

But as I said before, it is so new that we have to experience it.

Mr. LUKEN. All good things have to come to an end. We did say we were going to adjourn. We will give Mr. Williams the last word.

Mr. WILLIAMS. I just want to concur with what the chairman has already said. We really appreciate your time. It is very helpful to

get your input. A lot of people don't believe this system still works. I am one who does, which means the private sector has to contribute.

As the chairman indicated, it is good to get out of Washington, and into the city, and watch how you do it here.

Mr. LUKEN. Our thanks to Janice and John for bringing you all together.

Thank you.

[Whereupon, at 12:15 p.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

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